

A Special Report **May 6th, 2010** ***Managing Expectations***

As anyone who has ever had an important relationship knows, successfully managing expectations is the key to its long-term health. Effective and timely communication is essential to those efforts, and the following is my attempt to manage my clients' expectations for their future portfolio returns.

Projecting returns isn't an easy task in markets where volatility *isn't* high, or in economies where the government *isn't* piling up massive debt, or when even "developed" nations' sovereign debt *isn't* being downgraded to junk status. But it's especially difficult in times like these, where *all those conditions exist*. Despite these obstacles, equity prices have risen over 73% in a little more than a year.

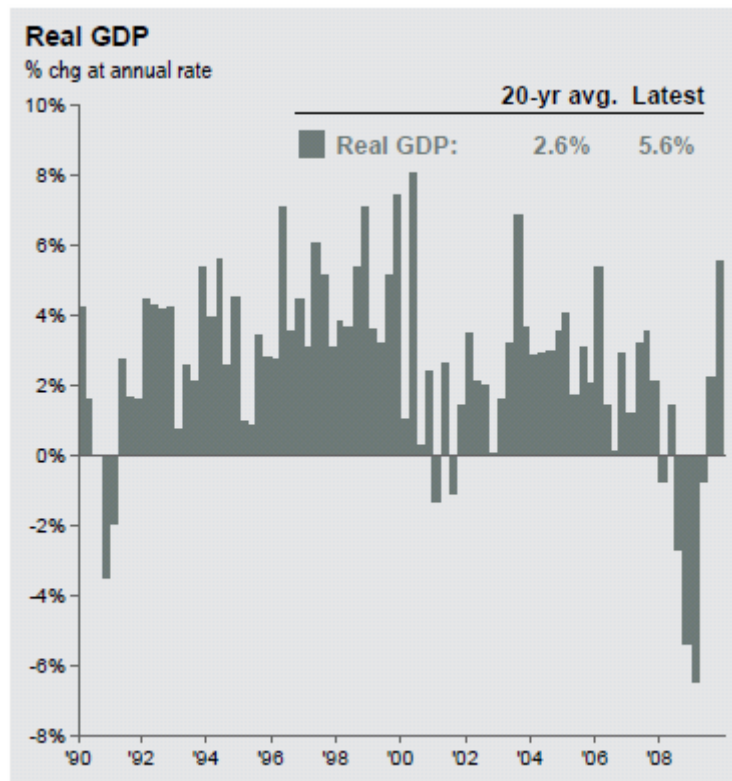
Schizophrenia is the closest word I can think of to describe the state of our current economic and market conditions. I think I can safely offer that in my twenty-seven year career, I have never seen an investing environment quite like the one in which we labor today.

Bullish Perspectives

From the perspective of those who see the economic and market glasses as "half-full" currently, it seems relatively clear that we've backed away from the economic and financial abyss we were peering into in late 2008, through early 2009. Like Punxsutawney Phil, popping his head out of his hole to predict the end of a long, hard winter, bullish prognosticators are basing their hopes that the worst of it may be behind us on some really encouraging economic data announcements delivered over recent weeks:

- The Conference Board recently announced that Consumer Confidence had reached its highest levels since September 2008.
- Retail spending data confirms that consumers are starting to (cautiously) open their wallets again.
- Year-over-year housing prices, as measured by the S&P/Case-Shiller Home Price Indices ticked positive in April for the first time since January 2007, providing hope that housing values and equity, a key container of American wealth, may have finally stopped declining.

- The Federal Reserve maintains an “accommodative” credit policy, and continues to reassure capital markets that they won’t “pull the punch bowl away” too early.
- Relative strength in key domestic sectors such as financials, technology, consumer non-durables, and health care, has improved of late.
- US corporate earnings announcements for the quarter just ended were surprisingly good once again, having risen dramatically on a year-over-year basis. These much improved earnings provide a better fundamental underpinning of equity prices generally.
- Unemployment, still at unacceptably high levels, has moderated, with new, and continuing claims having stabilized.
- Perhaps most importantly for those who are looking for reasons for optimism, was last Friday’s announcement that first quarter 2010 Gross Domestic Product (GDP) rose by 3.2%, the third consecutive quarterly report indicating *growth* in the US economy, following four consecutive quarterly declines.



Bullish investors see these positive indicators as evidence that “The Great Recession” may be over, if not yet officially announced, and that last year’s market improvement was warranted. Their hope is that continued improvement in these areas will at least sustain current price levels, and hopefully, spur even further gains.

Bearish Concerns

Against all of this improving economic and market data, more “bearish” investors are worried about the formation of “dark clouds” that are increasingly difficult to ignore, portending greater troubles to come:

- The US government has added \$3 trillion to our national debt over the past two fiscal years, with larger (cumulative) deficits to come.
- Greek sovereign debt has been downgraded to “junk” status, with the contagion likely soon to spread to the remaining members of the European “PIIGS” (Portugal, Ireland, Italy, Greece, and Spain).
- An estimated 14 million additional US homes will be foreclosed upon over the next two years, and domestic personal bankruptcy filings are at all-time highs.
- Corporate profits are up, but capacity utilization remains incredibly low.
- Even the most optimistic employment projections assume unemployment will remain very, very high for the foreseeable future.
- And despite the dramatic increase in equity prices, major equity indices remain (approx.) 23% below their pre-crash highs.

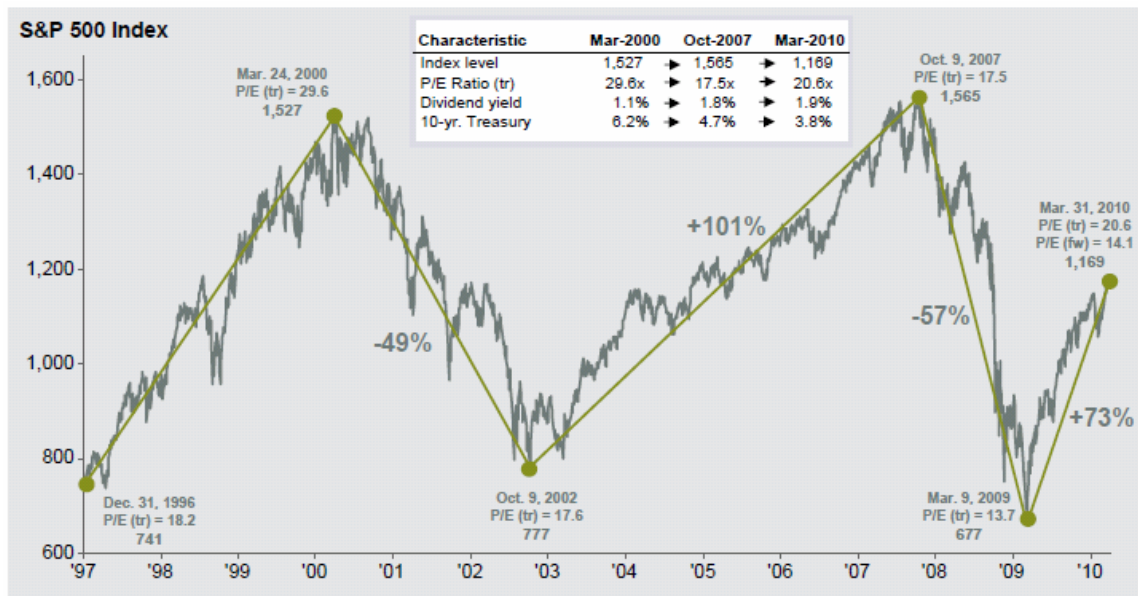
The bottom line for those who see the glass as “half-empty”? Their focus remains on the printing of trillions of Dollars and Euros by Global Central Banks to facilitate their absorption of massive amounts of questionable mortgages, persistently high rates of unemployment here and abroad, and continually growing numbers of US mortgage delinquencies and bankruptcy filings. All these combine to forewarn of higher inflation rates and (potentially) unsustainable government debt burdens in coming years.

How to Play Both Sides of the Coin

So the question remains: How does an investor position his/her portfolio amidst such conflicting conditions?

In my opinion, the answer is: actively, tactically, and **defensively**.

A year ago, I presented a White Paper to you entitled, “*The Way Forward*”, in which I posited that we were likely smack dab in the middle of a **secular bear market**, an environment in which markets cycle wildly up and down for periods of fifteen to twenty-two years, but for all practical purposes, don’t experience permanent advances. I provided as evidence at that time the facts that from early 2000 to April 2009, the S&P 500 Index, had ***fallen 49%*** (March 2000 – October 2002), ***risen 101%*** (October 2002 – October 2007), and ***fallen 57%*** (October 2007 – March 2009). The subsequent ***73% rally*** (March 2009 – present) leaves the Index today (approximately) ***still 20% below where it began the last decade***, only strengthening my convictions around the belief that we remain mired within a secular bear market.



Source: Standard & Poor's, First Call, Compustat, FactSet, J.P. Morgan Asset Management.

Is Another "Inflection Point" Approaching?

As for the current cycle's upturn, it seems to be rapidly losing strength. For the past nine trading days, we've seen some fairly wild swings in the equity markets, both on a closing, and intra-day basis. Volatility has increased in the most recent couple of weeks, punctuated by today's massive point swings. Here are the net point changes of the Dow Industrials the past week or so, and the daily "range" of those changes:

<u>Date</u>	<u>Point Change</u>	<u>Daily Range</u>
04/26/10	(- 3 points)	159 points
04/27/10	(- 179 points)	298 points
04/28/10	+ 15 points	278 points
04/29/10	+ 167 points	178 points
04/30/10	(- 172 points)	250 points
05/03/10	+ 100 points	280 points
05/04/10	(- 225 points)	199 points
05/05/10	+ 10 points	230 points
05/06/10	(- 348 points)	1,010 points

Swings of this magnitude, especially intra-day, often indicate a "topping" of a market, and warn that near-term caution may be appropriate. The low volatility that characterizes bull markets contributes to the comfort and confidence many investors feel during these periods. As you might expect, it's also true that the higher volatility that occurs during bear markets adds greatly to the discomfort and anxiety felt by investors who experience declining markets. These emotions can feed a market's decline and become a self-fulfilling prophesy.

In such volatile investment environments, a prudent manager will abandon strategic, “buy and hold” portfolio designs and replace them with tactical managers who will defend their assets when appropriate. A prudent manager, aware that permanent advances in a secular bear market are illusory, will raise cash when reversals appear on the horizon, and re-invest that cash when conditions appear to have improved. Tactical and defensive managers will attempt to *protect* investor capital, and occasionally, at the expense of potential (and likely short-lived) gains.

They will also increase the portfolio’s diversity, expanding the depth and breadth of asset classes represented within the portfolio, reducing the concentration of higher correlation investments that could cause dramatic downturns *when*, not *if*, equity markets collapse. These are the changes we implemented in the spring and summer of last year. We may have come to the realization that we were in a secular bear a bit late, but we were, and in my opinion, remain, well ahead of my professional colleagues in coming to this conclusion, most of whom who remain strategically allocated today.

In the aforementioned White Paper, we unveiled our new, “core/satellite” model strategy. Our intent was then, and remains today, to reduce permanent strategic (i.e. fixed) allocations to the “traditional” (stock and bond) markets, and replace them with tactical and defensive money managers in those markets. We’ve even diversified our equity and debt managers’ *approaches* to their respective markets, requiring each manager we hire to have both a “buy discipline” (reasons to *buy* stocks and bonds) and as importantly, a clearly articulated “sell discipline” (reasons to *sell* stocks and bonds). Given the market conditions of late, our managers have maintained their under-weights to global equity and debt markets for our investors across the board. These “core” (equity and debt) managers are either trend followers, using price history and (trailing) moving averages, or they use a “global macro” (i.e. top-down) momentum and relative (price) strength approach.

Our “satellite” managers are toiling in non-traditional asset classes that are intended to (1), evidence little to no “correlation” to the traditional stock and bond (i.e. “core”) market cycles, (2), deliver equity-like returns *over time*, and (3), reduce overall portfolio volatility. The combination of these tactical and defensive core managers, with the non-correlated satellite managers, should deliver smoother, less volatile results without sacrificing returns over time. These satellite managers, investing in real estate, commodities, managed futures, energy sectors, and market neutral strategies, will, again, *over time*, deliver returns that should keep up with the long-term real returns of equities, but often with counter-cyclical timing in relation to the equity and debt markets. The benefit of adding these non-traditional asset classes to the portfolio is that returns will be narrower in range, and devoid of dramatic declines that make recovery difficult.

The challenge, as always, is in predicting portfolio returns going forward. It should be clear that given our relatively low level of exposure to the global equity markets today (25% - 30% of portfolio assets currently), we will *not* benefit as previously from continued increases in equity market prices, should they persist in the coming months.

However, the reverse is also true. We should not suffer declines of the magnitude as previously seen in portfolios with higher strategic allocations to the equity markets when, not if, equity markets reverse their recent cyclical climb.

This defensive approach is articulated by our *tactical* “core” managers as a “*win, by not losing*” strategy. If these tactical managers can avoid “the big loss” in years like 2002 and 2008, and if our satellite managers can deliver their historical (not guaranteed) returns over time, the resultant narrower annual return “ranges” should allow us to outperform an all-equity, or predominantly equity-oriented portfolio over multiple market cycles. If past is prologue, the avoidance of big losses provides me and my clients with the comfort of believing another sharp reversal in the economy or equity markets will not severely impact our portfolios’ returns or derail their plans for those assets.

In Closing

In summary, we adopted this “core/satellite” endowment-like model to protect our clients from another meltdown. While it has yet to occur, we still believe it will. We’re confident that our strategy has the potential to succeed in protecting assets should such a meltdown recur.

And while it’s popular to debate whether or not stocks are going to continue their recent ascent in the coming weeks and months, the truth is that the evidence is as inconclusive as the ongoing releases of contradictory economic data points that seem to confound and confuse bulls and bears every day.

Despite these contradictory data, and regardless the accuracy of our near-term market prognostications, recent experience convinces us of one thing. **Our clients simply don’t want the risk of a 100% stock portfolio.** They don’t want the risks of strategic, fixed allocations to these volatile markets. We’ve heard loudly and clearly that they never again wish to experience the magnitude of the equity market declines seen in 2000 – 2002, or in 2007 – 2008. Our goal is to provide these clients with a multi-asset portfolio that mitigates risk and manages volatility, yet has good historical, and hopefully pro forma, return characteristics. Over time, we hope to “win, by not losing”.

As always, we welcome your comments and questions.

- JRP

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