



January 2010

MARKET REVIEW

At the beginning of 2009, fear that the financial system might implode reigned.

In early March, the Federal Reserve (the Fed) and the new administration made clear that they would take whatever measures were necessary to sustain the financial system and revive the economy. The Fed has maintained the Fed funds rate at 0.00% to 0.25%, committed to “exceptionally low levels” for an extended period and pumped reserves into the financial system by buying longer maturity debt including mortgage-backed, asset-backed and even Treasury securities. Similar stimulus policies have been implemented across Europe, in China and (to a lesser extent) in other countries. With virtually no return on short-term investments, investors piled into riskier assets around the world, driving longer-term interest rates lower and stock prices higher, as you can see in Table I, which uses the month-end closest to the lows.

Table I	Total Cumulative Returns %			
	2009	Bear Market	Current Rally	Peak
Russell 3000	28.34	-50.30	56.49	-22.23
Russell 1000	28.43	-50.27	55.97	-22.44
Russell 2000	27.17	-50.67	62.88	-19.65
MSCI World ex U.S.	34.39	-54.44	64.81	-24.91
	12/31/08 to 12/31/09	9/30/07 to 2/28/09	02/28/09 to 12/31/09	9/30/07 to 12/31/09

Source: Lipper LANA

Equity returns from the early March lows have been on par with other market recoveries following major bear markets, such as 1976 and 2003. However, equities remain substantially below the peak levels of 2007. Real estate values are substantially below the peaks of 2006. In fact, housing values are now estimated to approximate those at the beginning of the decade. On the other hand, even though fixed income investors were bruised in the credit squeeze, they earned more than 5% annualized over the decade.

At the beginning of the last decade, we expressed concern regarding future equity returns. Needless to say, we were not negative enough. This has been the worst decade for equity investors since the 1930s and the only other negative decade in the last 200 years, as measured by the Dow Jones Industrials and the Standard & Poor’s (S&P) 500. We

have had two major bear markets during the last ten years; the earlier bear market was much more severe for large-cap stocks than small-caps; the most recent bear market was equally bad for all equity markets around the world.

Among sectors in the U.S., technology stocks remain more than 50% below their peaks at the beginning of the decade; financials roared to all-time peaks in 2007 but are still more than 50% below that; natural resources stocks were the best for the decade. International stocks gained more than U.S. stocks.

Over the past decade, the cumulative total return of the Russell 3000 Growth is -32% and the Russell 3000 Value is +33%. After the emerging market debt crisis of 1998, emerging market stocks have been the real leaders of the last decade.

1930s
2000s

EQUITY
Only two
negative decades
- Last 200 years -

What is Normal?

The “new normal” hypothesis promulgated by PIMCO, a leading global investment advisor, holds that future economic growth and investment returns will be low single digits as a result of strained government and consumer balance sheets, increased regulation, aging baby boomers and foreign competition. What is the “old normal?” Perceptions and reality often differ.

An individual’s investing career lasts more than 40 years, which would also encompass the investment horizon of most pension plans, endowments and foundations. Returns varied widely by decade but, over 40 years, investors have earned higher returns on riskier assets as shown in Table II. We can learn from history but need to evaluate the circumstances of each period to reduce the possibility of repeating past mistakes.

Returns are influenced by changes in the level of interest rates and in valuation levels as measured by price/earnings (P/Es) ratios, which you can see by comparing returns for each decade in Table II with the beginning and ending interest rates and P/Es in Table III.

Each decade included a few defining events: the oil embargo and soaring inflation expectations coupled with wage and price controls of the 1970s; unwinding inflation, declining interest rates and supply-side economics’ tax cuts of the 1980s; the technology boom, balanced budgets, spreading democracy and freer markets of the 1990s; and financial engineering and mushrooming budget deficits of the 2000s. However, two major events of the 2000s affected the relationship between interest rates and P/E, especially when using the S&P 500 and 10-year Treasury bond yields. At the beginning of the decade, the technology sector constituted approximately one-third of the S&P 500 and sold at astronomical P/Es. Valuations have more than halved since then. At the end of the decade, yields (especially of Treasuries) were made artificially low by the Fed’s efforts.

	Total Annualized Returns %				
	1970s	1980s	1990s	2000s	12/31/69 to 12/31/09
Consumer Price Index (CPI) ¹	7.4	5.1	2.9	2.6	4.5
3-Month Treasury Bills	6.5	9.2	5.0	2.7	5.8
10-Year Treasury Bonds	7.5	10.6	6.7	4.5	7.3
S&P 500	5.9	17.6	18.2	-1.0	10.2
MSCI World ex U.S.	10.9	21.5	7.4	2.0	10.5

Sources: U.S. Treasury, Standard & Poor's, Lipper LANA, MSCI and Zephyr

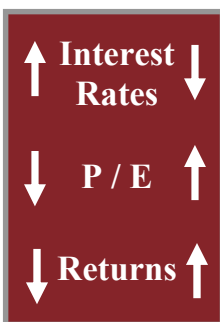
¹ Average over period

● Highest return for decade ● Lowest return for decade

	Decade Beginning and Ending Comparisons				
	1960s	1970s	1980s	1990s	2000s
Interest Rate/Yields ¹					
Beginning %	4.7	7.8	10.8	8.2	6.7
Ending %	7.8	10.8	8.2	6.7	3.6
S&P 500 P/E ²					
Beginning	17.7x	15.9x	7.3x	15.5x	30.5x
Ending	15.9x	7.3x	15.5x	30.5x	22.6x

Sources: U.S. Treasury and Standard & Poor's

¹ 10-Year Treasury ² Reported Earnings



What are beginning values for the coming decade? Investors expect inflation of 2.5 to 3.0% based upon the current CPI swap rate. A zero coupon 10-year Treasury, which has no reinvestment risk, is selling to yield 3.95%. Corporate bonds add more return potential than Treasuries. Not only are yields higher but corporations with publicly traded debt also have better balance sheets than the U.S. government. Over long periods, i.e. many decades, corporate profits tend to grow at about a 7% rate. However, future profit growth may be curtailed by higher taxes, costly regulation and rising costs of materials without the ability to raise selling prices in a globally competitive market. Perhaps future profit growth averages 6% annually. Current dividend yields approximate 2%. Dividends can also grow. So equity returns over the next decade could be about 8%. Of course, equity returns vary widely.

Just consider returns over the last two decades for the technology and financial sectors or foreign stocks (MSCI World ex U.S.) compared to domestic stocks (Russell) as shown in Table IV. As we saw in Table III, a big factor affecting equity returns is the change in valuation. Currently, equity valuations as measured by P/Es are in-line with long-term averages. With interest rates low, P/Es could rise. P/Es are affected by long-term interest rates and much less by short-term interest rates, which have no where to go but up. However, if long-term interest rates rise, then P/E expansion would be

	Total Cumulative Returns %	
	1990s	2000s
S&P 500 IT	1285.25	-51.52
S&P 500 Financials	456.24	-23.22
Russell 3000 Index	409.93	-2.02
MSCI World ex U.S.	104.82	22.35

Source: Lipper LANA

difficult. As a result, expecting the high returns of the 1980s and 1990s from bonds and stocks is improbable. Planning on it can lead to disappointment.

Long-Term vs. Short-Term / Balancing Opportunity and Risk

Long-term trends affect the rate of economic growth, the quality of life and returns on financial assets. Last quarter we analyzed demographic data, which is one area of more certainty than other trends we may consider. Government policies are another significant factor.

As we begin this decade, economies around the world are attempting to recover from the “Great Recession.” How governments have chosen to address their challenges varies widely. Most disconcerting, in our opinion, are the different fiscal policy responses of U.S. and China. U.S. fiscal policy provided consumer tax cuts aimed at the low and middle income population and programs that are geared to boost consumption and/or address problems that consumers have with heavy debt burdens. Little is being spent to boost investment or encourage savings rather than consumption.

Current Fiscal Policy

U.S. = Consumer

China = Investment



On the other hand, most of the fiscal stimulus in China is aimed at boosting manufacturing capacity or public works programs. China would benefit from programs designed to boost domestic consumption rather than build more capacity to export products to consumers elsewhere, primarily the U.S. These policies may lead to future problems for both countries. Since the U.S. and China are the two biggest economies in the world, the health of both has global implications.

Certainly technology will continue to affect how we live and do business. Perhaps the biggest areas of opportunity are in how we use energy and the effects on the environment. What if most new cars in Asia are electric? Asian car buyers are most often first-time buyers, while American and European car buyers are replacing existing cars. So the effect on incremental demand for gasoline could be huge. We would need more electricity to power those new cars. If nuclear power plants are built instead of fossil fuel plants, it would change the nature of energy demand. The other area of significant potential to affect how we live is biomedical technology. Energy, environment and biomedical technologies could be as disruptive in the coming decade as communication technologies have been in the last decade (think laptops and handheld devices, the Internet and cell phones). Contemplating these opportunities is fascinating.

What if most new cars in Asia are electric?

Only 202 of the S&P 500 companies in 1980 still exist today. Over the last 30 years, pro-democracy governments have grown

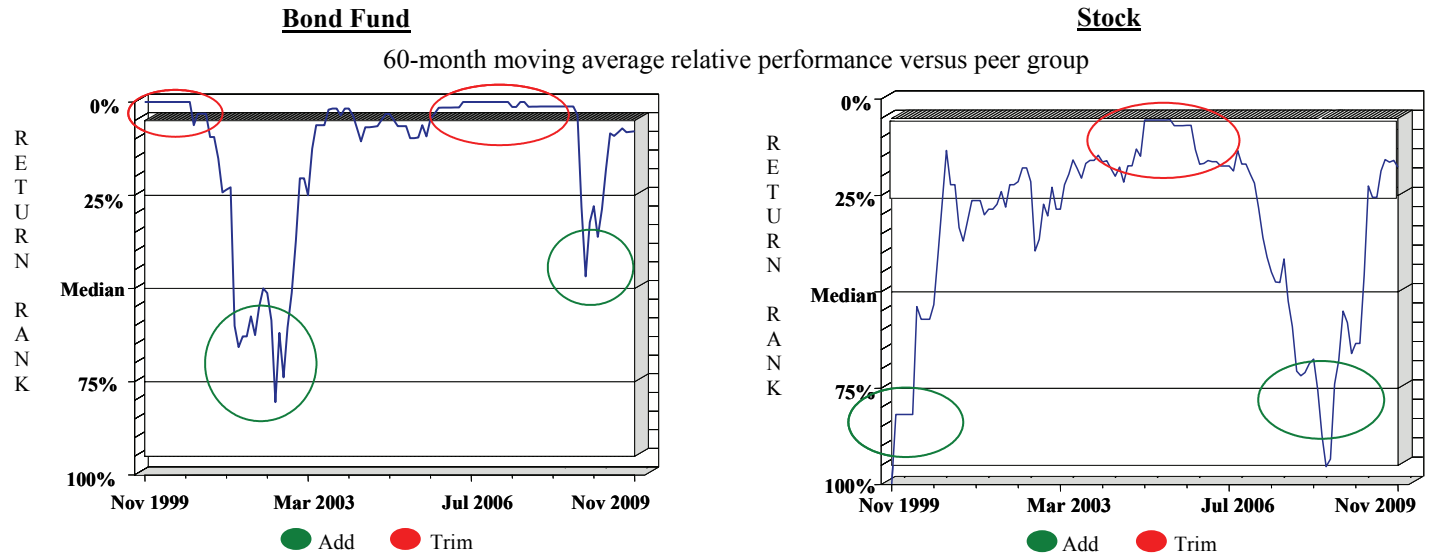
from 40% of the world’s governments to over 60%, according to *The Economist*. The rise of democracy has occurred during a “pro-business” revolution that has not only fostered rising standards of living and business opportunities, but also creative destruction as part of process. Just consider what the Internet has done to newspapers.

Whether the next decade can sustain the 30-year trend towards freedom and capitalism will be a major determinant of future returns.

Over the next 12 to 18 months, the economy will likely continue to improve and with it profits will increase. In spite of the money that has been invested in riskier assets in the last nine months, the amount available for investment in financial assets is immense. According to JP Morgan Asset Management, investment reserves peaked in March of 2009 at \$2,286 billion and have declined about \$266 billion through November. So long as the investment environment continues to improve, fostering investor confidence, investors are likely to seek the higher return potential of riskier assets. To sustain economic recovery, banks need to lend to small business, the source of most job creation. (Large companies can borrow in the public bond market and have done so at a record rate, raising over \$1.15 trillion in 2009.) Recent data indicates that job losses have slowed dramatically. However, the small decline in the unemployment rate reported in December was not the result of new jobs but discouraged job seekers abandoning the search for work. Improved profits reported by companies are primarily the result of cost-cutting, not revenue growth. Consumers have made progress re-dressing their balance sheets, but without income growth spending growth will be difficult. The only growth in aggregate personal income in 2009 was the result of government transfer payments. The consumer remains two-thirds of the economy. The financial system remains fragile. Government programs to purchase agency and mortgage bonds are scheduled to end in the spring. All but the biggest banks remain vulnerable to continued weakness in residential and commercial real estate. The stock market appears to have already discounted much of the improvement.

Strategy Considerations

We continuously analyze performance data. Few managers consistently outperform. However, some managers produce above average relative performance and absolute returns over time. We can add to these returns by emphasizing or de-emphasizing a manager that tends to follow certain relative performance patterns. Consider the relative performance of the two funds in the graphs below. One invests in bonds, the other in stocks. Each has produced solid relative and absolute performance over time. However, trimming when relative results are extremely high and adding when poor can augment returns. This requires discipline, vigilance and patience.



The risk that reality does not meet expectations has grown large. Therefore, we are reviewing funds and managers to consider how each performs in an environment where volatility again increases and the importance of security selection heightens. Remember that volatility creates opportunity. We favor investing in larger and multi-national companies after a decade when small-cap stocks outperformed. Not only are larger-cap stocks now selling at lower valuations than smaller-caps, but multi-national companies have global growth opportunities and are generally able to manage currency risks. Finally, we continue to favor corporate bonds and to take advantage of

the still steep yield curve, particularly since yields beyond two years rose substantially in December.

Although we believe the next decade will be more rewarding for equity investors than the last, we also believe that returns will be more similar to those of the last 40 years than those of the 1980 to 2000 period. Fixed income investors will be happy, if they earn the coupon return. We combine attention to relative risk, opportunity among asset classes, strategies to manage valuation risk and sensitivity to the risk of permanent capital impairment in our effort to meet clients' investment goals.

“It is largely fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them.” John Maynard Keynes

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