



Investment Commentary

January 2010

As we note in the commentary that follows, we aren't overly enthusiastic about the multiyear return potential from either stocks or bonds at current valuations, but are optimistic that periodic dysfunction in the markets will allow our managers to continue to find opportunities as well as allow us to take advantage of tactical opportunities. The incremental value of these opportunities may be much lower than it was this past year, where absolute returns were unusually high, but in a low-return environment they can make a material difference.

Odds, Payoffs, and Patience

We've enjoyed healthy returns this year after a harrowing 2008. But, we head into 2010 and beyond knowing that there's no time to enjoy the good feeling of a successful year—the world and the markets don't give us that luxury. As we look ahead over the next several years, despite the beginnings of an economic recovery that at this point has been mostly government supported, we continue to believe that the weight of the evidence makes a strong case for a tough road for the economy and the financial markets. How this will play out over the shorter term of the next year is less clear, with a wide range of possible outcomes, from positive to negative.

Debt, Debt, and More Debt

We continue to believe that we are in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the acceleration of the buildup of our public (government) debt.

Household Debt: Households have hit a debt wall and are in the process of deleveraging. Despite the huge government stimulus, this process is not close to being over. Household debt levels doubled in the last decade on an absolute basis and were 50% higher when compared to the overall economy (GDP)*. At 99% of GDP, household debt is barely off its all-time high. Debt levels along with sizable wealth destruction (due to declining home equity and stocks), high unemployment, and uncertainty about the economic future have triggered a reality check. Private debt levels are being paid down at a faster rate than we've seen since the mid-1960s and probably for many years before that (our data only goes back to 1966). However, debt levels that expanded over decades can't be taken down to more prudent levels in a few quarters. It will take time. Moreover, though interest rates are low, debt is generally less available for those who want or need to borrow as lenders have shifted from almost nonexistent underwriting standards to a world of highly cautious lending.

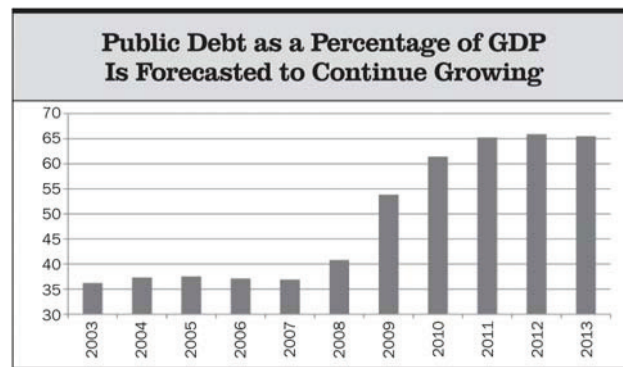
Consumer Spending Headwinds: Because consumer spending is 70% of the economy it is hugely important to overall economic growth. The desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it very likely that

* Source: Litman/Gregory Analytics



consumption growth will be subpar compared to what we've been used to. Personal consumption expenditures contracted for several quarters before rebounding in the third quarter, largely thanks to the surge in auto purchases triggered by the Cash for Clunkers program. Prior to hitting the wall, consumers had made a habit of borrowing in order to spend, but that is no longer the case. Not only are households in aggregate no longer borrowing to spend, they are now actually paying off debt. This is a big swing factor that directly impacts spending levels. Even if debt growth resumes it will be a long time before it grows at the rate it did over the past decade. This does not bode well for spending, which affects overall economic growth, and then ultimately, jobs.

U.S. Government Debt Explosion: Governments around the world have been filling the vacuum created by the consumer retrenchment with extremely expansionary monetary and fiscal policy. The U.S. government has been particularly aggressive and in aggregate its actions probably saved us from a 1930s-type depression. However, the resulting leap in the government deficit comes at a terrible time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the United States faces extremely challenging times in coming years.



Stimulus spending and falling tax receipts have caused a spike in public debt. The debt burden is forecast to worsen significantly due to the increasing cost of entitlement programs like Medicare and Social Security, and of servicing the national debt.[†]

The financing of our public debt has not been a problem so far because the financial crisis created a surge in investor demand for U.S.-backed debt and contributed to rock-bottom interest rates. But it will get more challenging. It's estimated that the U.S. government will need to

[†] Source: Litman/Gregory Analytics



borrow \$3.5 trillion over the next three years. Additionally, over the next year about \$1.6 trillion of debt is maturing and will have to be rolled over. Now, with much of the developed world facing similar problems and needing to borrow, and increased risk appetites resulting in less demand for government paper, borrowing rates are likely to rise at least a bit over the next couple of years. A recent New York Times article stated that a 1% rise in the average interest rate will cost U.S. taxpayers \$80 billion in additional debt service costs—equal to the combined budgets of the departments of energy and education.

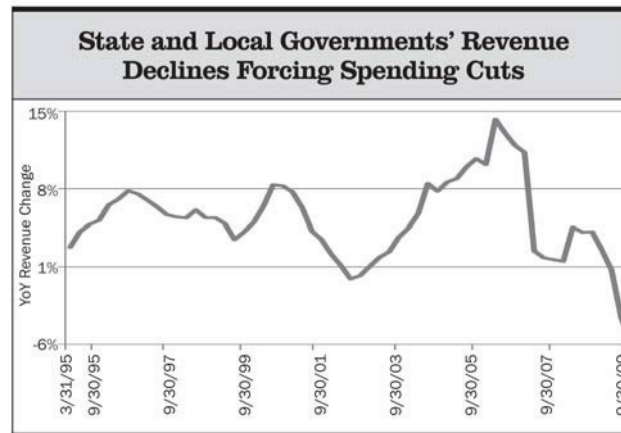
But, it is in the intermediate term that financing the public debt gets scary. U.S. government debt is now \$12 trillion. More troubling is the estimated present value of future unfunded liabilities—mostly Medicare and Medicaid—which is a difficult-to-comprehend \$60 trillion (equal to about five times annual GDP). As debt continues to grow, at some point it will become difficult to get investors to lend to a fiscally challenged United States in the amounts needed, without paying a significantly higher interest rate. Though some increase in borrowing costs is likely soon, the risk of a sharp increase in rates is not imminent if the recovery is subpar (as seems very likely). Also, even though government spending will stay high while the economy is weak, it will decline at the margin and coupled with the improvements at the margin in the economy, the annual deficit will decline in the near term. But looking out over the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and spending will have to decrease. If this doesn't happen in a significant way, and maybe even if it does, there is a great risk of both a dollar and an interest-rate crisis that could be extremely painful for the United States and global economies. Dealing with these coming problems can't be put off much longer. It is quite possible that the U.S. government will begin to face financing pressure within our five-year investment time horizon.

There are still many variables in play that relate to the above-mentioned overriding concerns, including:

- High productivity and worries about consumer spending suggest that businesses will not be quick to hire and therefore the labor market will not improve rapidly after likely bottoming in 2010.
- Though some housing variables are improving, the wave of upcoming foreclosures and continued high unemployment make it less than clear that home prices have actually bottomed. This is potentially bad news considering that about 25% of homeowners (about 11 million households) with mortgages currently owe more than their home is worth.
- Small businesses are suffering from weak demand and a larger decline in profits than bigger firms. The larger profit decline appears to be due to less-aggressive layoffs and expense cuts in general. This is important because small businesses account for more than half of the country's jobs and the outlook for hiring on the part of small business is not good in the near term.
- Collectively, states and municipalities are suffering from the steepest decline in tax revenue on record. Because most must balance their budgets they are forced to cut spending and jobs. This offsets some of the government stimulus from the federal level.



Forecasts by the Center on Budget and Policy Priorities suggest that the economic drag from state and local governments could actually increase and cost about 1% of GDP over the next couple of years. The increase is partly due to reduced federal assistance as stimulus is withdrawn. Longer term, large unfunded pension liabilities and increasing health costs make it likely that state budget shortfalls will continue for years.



Steep declines in tax revenues are forcing spending and job cuts at the state and local government level. Source: U.S. Census Bureau.

- Banks' profitability has improved recently thanks to their ability to leverage their cheap borrowing rates and buy securities with higher yields. However, loan delinquency rates continue to increase. Recently an International Monetary Fund official was quoted as saying that it's possible that 50% of eventual bank losses may not be reflected on bank balance sheets. Smaller local banks and regional banks appear to be more at risk due to large exposure to commercial real estate loans. In short, the financial sector appears to have a ways to go in its deleveraging process. As long as financial institutions stay in a balance sheet rebuilding mode, we won't see robust lending growth.
- Much of the developed world remains stressed even though a global recovery appears to be underway. Southern Europe (Greece, Spain, Italy, and Portugal) have huge deficits and debt but don't have the policy lever of allowing their currency to weaken because their currency is the euro. It's possible that some form of bailout may be needed for some of these countries. Meanwhile, Japan is falling deeper into deflation.
- Finally, given the challenges, there is risk of policy mistakes as the Fed and the Treasury attempt to maneuver through the next few years. Extreme partisan politics will make an already difficult job far tougher. Unwinding of the stimulus at the right time and in the right way will be one of the big challenges. At what point the economy can stand on its own remains an open question, not just in the United States but in most of Europe and Japan as well.



There are some positives:

- This is the largest global stimulus ever to occur in peace time.
- The strength of the emerging-markets economies feeds back into the global economy and is a positive for exports and manufacturing.
- Corporate balance sheets, outside of financials, are in good shape including the best liquidity in 50 years. Some believe this will support investment.
- Inventories are low and a rebuilding cycle is beginning, which will support some growth.
- The severity of the economic contraction and corporate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring (not likely in our view).

We don't dismiss the positives as they explain why some recovery is likely to be sustained. However, we continue to believe that the weight of the evidence makes a strong case for a sustainable but subpar economic recovery, with a risk of falling back into recession at some point in the next two years as the stimulus is unwound. In thinking about what lies immediately ahead, it is interesting to consider an opinion piece that appeared in the Wall Street Journal on December 16, 2009, penned by Alan Blinder, an economics professor at Princeton and former Fed vice chairman. The piece, "The Case for Optimism on the Economy," concludes with the following:

I warned at the outset that I would present a deliberately biased case. So let me admit, once again, that serious downside risks remain. The investment slingshot and the fiscal stimulus will both peter out in 2010. Consumer finances and confidence are shaky. Banks are still failing and commercial real estate is a mess. We cannot count on exports to pull us out of this slump. All true. And all reasons not to expect the kind of exuberant boom that typically follows a deep recession—such as the 7.7% growth spurt in the six quarters following the 1981-82 slump. No one expects that.

So my optimism is guarded. The 3%-4% growth rate that I anticipate for the rest of this year and for 2010 is a lot worse than 7.7%, to be sure. But compared to what we've been through, it will feel a whole lot better.

Blinder's 2010 growth forecast would be viewed by some as optimistic (including the few forecasters we respect) and perhaps that is why he calls it "a deliberately biased case." But it's his acknowledgement of all the risk factors and his general statement that "serious downside risks remain" that comes across as a powerful caveat to his optimism and seems to us to undermine the conviction in the argument. And as he states, 3% to 4% growth—if we get that in 2010—is hardly a robust recovery coming out of an extremely deep recession.



Return Expectations

We assess return potential via scenario analysis that incorporates our assessment of asset-class pricing and fundamentals and how they are likely to be impacted under various economic possibilities (discussed above) over the next five years.



Source: Ned Davis Research Inc.†

In going through this process we come away discouraged. With the run-up in prices of global equities[§], most of our valuation metrics suggest stocks are somewhat overvalued based on history, and more overvalued if the subpar growth we expect becomes reality. Corporate and high-yield bonds^{**} are not overvalued but they are no longer cheap. U.S. government bonds are priced to deliver poor returns over five years, barring a severe deflationary world. With historically low dividend yields of less than 4%, REITs^{††} are also overvalued. Only emerging-markets local-currency (non-dollar) bonds look reasonably attractive in most scenarios but even they are subject to a fairly high level of short-term risk stemming from currency fluctuations. In short, no asset class appears priced to generate fabulous returns—though some asset classes will do better than others and there are specific investments that look somewhat attractive. Only in our most optimistic scenario are the expected returns for equities into double digits, with developed market returns above 10% and emerging-markets equities^{‡‡} returns in the mid teens.

† Three-Month T-Bills track short-term U.S. government debt instruments

§ The Morgan Stanley Capital International Europe, Australia and Far East Index (**MSCI EAFE Index**) is a widely recognized benchmark of non-U.S. stock markets. It is an unmanaged index composed of a sample of companies representative of the market structure of 20 European and Pacific Basin countries.

** High yield bonds pose substantial risk such as liquidity risk, default risk and credit spread risk.

†† REIT performance measured by the NAREIT index which tracks the performance of the largest US publicly traded REITs. All Indexes are unmanaged composites and do not include deduction of fees or trading costs. These may lower returns. It is not possible to invest directly in an index.

‡‡ Investing in emerging markets bears substantial risks such as currency risks, political risks and liquidity risks.



However, we put a low probability on this optimistic scenario playing out. In the other scenarios, mainstream asset-class returns are very low and in some cases slightly negative.

Though we believe our less-than-bullish five-year view is strongly supported by the weight of the evidence, there are countervailing forces that are fighting it out in the short term. The biggest positive factor in the short term is that interest rates on cash and quality bonds are extremely low—investors are not being “paid to wait.” Cash returns are still in the neighborhood of zero. Ten-year Treasury notes^{§§} yield less than 4% with longer-term price risk. With the global economy still in a very weak state, it seems likely that most central banks will seek to keep interest rates low. (In mid-December the Federal Reserve again reiterated its view that economic conditions in the United States “are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”) These low interest rates create a strong incentive for investors to take some risk with their money and seek higher potential returns. Risk appetites are further supported by the good feelings resulting from the strong market rebound off the extreme bottom of last March, and the improvement of the economy from an alarmingly weak level. It is worth mentioning that many emerging markets tie their currencies to the dollar, which forces them to follow the Fed’s interest rate policy. This results in excessively low interest rates relative to their economic strength and serves as rocket fuel for their already strong economies and some overflow demand for other global “risk” assets (e.g., high-yield bonds).

If interest rates stay low, which is likely for a while, and the recovery takes hold as is also likely, it is possible that equities and other risk assets could deliver double-digit returns in 2010. However, if the economy doesn’t continue to strengthen, investors could get spooked and we could experience another sharp leg down in asset prices. While we don’t consider this probable, we don’t view the possibility as remote either.

Bad Odds and Not Much of a Payoff

“The ability to say ‘no’ is a tremendous advantage for an investor.”
—Warren Buffett

We must always consider how much risk we should take. We assess this based on multiple factors including short-term downside risk and longer-term upside in various scenarios. There is always potential tension between our long-term view and possible short-term outcomes. Some of that tension is present today. If the markets do manage to extend their gains into 2010, investors who took on more risk will be happy and feel smart. Those investors should be happy, but should they feel smart? We don’t think so.

^{§§} 10 year Treasury notes track long-term U.S. government debt instruments.



Investing requires one to make decisions with incomplete information and therefore uncertain outcomes. For this reason we believe we must have an understanding of the odds and the payoffs. We use our scenario analysis and valuation work to help us play oddsmaker and understand the upside we gain in exchange for taking risk. Ultimately we want the odds heavily in favor of the decisions we make. But having the odds in our favor does not mean that we will be right immediately or even at all. And taking risks that are not supported by the odds doesn't mean that an investor will be wrong. But it also doesn't mean they made a good decision. Sometimes it just means they got lucky. Lucky investors should not feel smart, though inevitably they do. Investors can sometimes get lucky betting against the odds, but over an investment lifetime that cannot continue. So playing the odds based on our analysis won't result in all of our decisions working out, especially in the short run. But over the long run our discipline, which implicitly requires us to be willing to be wrong in the short run, has added value by putting us in a position to be right far more than we have been wrong.

Given the risks we see, coupled with the return outlook in most scenarios (including our view that the upside in the optimistic case is good but not compelling), we must conclude that we do not like the odds nor are we tempted by the potential rewards for taking risk. Risk reduction seems the prudent course of action and that is the decision we have made across all of our balanced accounts. Most recently, we are eliminating our emerging-markets equity positions in all of our balanced portfolios (but not in our equity portfolios). After the huge rally it is no longer priced at a level that meets our standard for a fat-pitch tactical opportunity. That leaves our overall equity exposure now significantly below our neutral weighting and our overall risk exposure further reduced in all of our balanced portfolios. We continue to maintain some equity exposure 1) in case we are wrong and something akin to our optimistic scenario plays out; and 2) because we believe that over time our active managers, most of whom are focused stock-pickers, will add value over the broad market indexes and get us closer to acceptable returns. We are also likely to reduce our high-yield bond exposure in the near future after benefitting from its huge run-up in 2009.

Stocks Aren't Cheap, But Some Bond Sectors Offer Promise

We are starting to see articles in the financial press scolding investors for pouring money into bond investments after 10 years of lousy equity returns, and we disagree with their analysis. The assumption reflected in these articles is that equities will have good returns in coming years because the last 10 were bad, and that because bond yields are low, bond returns will be poor. Though equities usually do well after long periods of poor performance, there have been instances when they have continued to struggle and these have occurred after a major debt bust like we are experiencing. As discussed above and based on our very detailed analysis, we don't believe stocks are cheap enough to discount the period of weak growth that seems likely in an economy that is deleveraging. Moreover, we are headed into a period of increased regulation and taxation which will add to growth headwinds. With respect to bonds, it is true that rates are low and this will limit returns. U.S. government securities look particularly unattractive unless we fall back into recession. However, much of the non-government bond market (corporate and agency mortgages), while no longer cheap, is priced to deliver mid-single-digit returns over the



next few years with far less risk than equities—we strongly believe most segments of the bond market will perform much better than they did in 2008 if there is another meaningful downturn in the next year or two. If we look out 10 years, stocks may win. But, over five years that is less likely even before taking into account the risk.

So, we have built sizable bond positions while we wait for better opportunities. It is extremely unlikely that we will need to maintain these large bond allocations for most of our five-year horizon, but for now we are quite comfortable holding these positions. We should note that we are cognizant of inflation risk, which would be bad news for bonds, though we don't see that risk as imminent. Nevertheless, a significant portion of our taxable bond positions are in investments that have flexibility to make adjustments in a rising-interest-rate environment or give us exposure that can mitigate the impact of rising inflation.

For taxable clients, we are maintaining our tax-exempt bond holdings with slightly longer maturity exposure because yields there are somewhat elevated compared to taxable bonds. Though these bonds are at risk if rates rise, yields are high enough to provide some protection.

Overall, we have sizable exposure to different segments of the bond market that we believe, in aggregate, are likely to deliver mid-single-digit returns.

If We Wait, Opportunities Will Come

“People ask me what I do in winter when there’s no baseball. I’ll tell you what I do. I stare out the window and wait for spring.”

—Rogers Hornsby (Hall of Fame baseball player)

Looking out over our five-year window, if we simply invested in equities and bonds and held them without making any tactical moves, we would expect returns to be in the low single-digit range, with results being driven by the risk level of each portfolio strategy. However, we expect some of the bond niches we have access to will add incremental value. Emerging-markets local-currency bonds are the best example. There is also potential added value from active management of equities and fixed-income investments. These factors could raise expected returns into the mid-single-digit range (again this will vary based on the strategy). However, though we are long-term investors, static buy, hold, and simply rebalance approach does not make sense to us. Market swings occasionally give us opportunities to do much better. Consider that in 1982 stocks were priced at a fraction of their early 2000 level. Does it make sense that stocks were equally attractive at both times? Were high-yield bonds as attractive in 2006 when yields were less than 8% as they were late last year with yields over 20%? Clearly, the answer to both these questions is no. Looking forward over the next five years we believe higher returns can be captured by:

- Adding alternative strategies if opportunities arise. We believe it is likely that we will identify alternative strategies that could improve portfolio returns, albeit not dramatically.



- Making aggressive tactical moves when the odds improve. One thing we know is that great opportunities do present themselves over the course of a market cycle. Given the economic challenges we've outlined, we believe it is likely that the markets will present us with some compelling opportunities over our decision time-horizon. If price declines create bargains in some asset classes we will have an opportunity to move some capital out of our more defensive bond investments into potentially higher returning investments. In a low-return world, this source of added return could be quite material.

Our goal is to patiently wait for opportunities and then act to materially raise portfolio returns over our five-year decision horizon to a much more satisfying level. If our static asset-class return expectations are right, then we believe with value added from our fat-pitch tactical approach a high single-digit return range is a realistic goal over five years (again this will vary based on the portfolio strategy and there will be shorter time periods in which returns will be higher and lower). Of course, while seeking to maximize longer-term returns, we will also continue to manage each portfolio relative to its risk objective.

The waiting patiently part of our approach in this environment has become very important. We are now postured significantly away from our benchmarks with a sizable underweight to stocks in all of our portfolios. If stocks slump in the near term we will look smart and we could have an opportunity to take risks with much better odds and higher payoffs. But if stocks do well over the next months or year we will almost certainly underperform our benchmarks and our decision won't look "smart" when assessed solely based on a single, shorter time period. But we view investing as a marathon, not a sprint. We seek to do well when judged over the entire race, not just any particular mile. We're investing with that in mind, and as always appreciate your confidence and trust.

Please feel free to contact us if you have any questions or seek assistance in your investment and wealth planning for you, your trusts, estates, retirement plans, IRAs or business accounts.

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