

# Investment Update



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## Wind Power

As any hot air balloon enthusiast, glider pilot, politician or investor knows, the same wind that can loft one to new heights can shift on a whim and turn against you. Mild bumps quickly can become unsettling turbulence. At times, the wind can pick up so dramatically that an entire landscape is altered. Hot air balloon pilots can only control the balloon through ascent or descent, using wind currents to change direction and leaving little room for mid-flight course corrections. To reduce this margin of error, some precautionary measures are taken. For instance, hot air balloons tend to launch in early morning or late afternoon, when ill winds are less likely, and aviation laws provide certain protections from larger, powered planes and gliders.

Investors have more leeway with which to steer their course. However, rigid portfolio strategies that do not account for variable conditions could prevent investors from landing in their desired location. Recent events in both the political and investment arenas appear to be causing some wind shifts. Regardless of whether a pilot thinks the new wind direction ultimately may lead to a favorable destination, if he plots his course resolutely north while the wind shifts south, he will be in for an arduous journey.

## Fairy Tale Markets

A strategist friend of mine recently related an inquiry he received from an institutional portfolio manager. This manager wondered if we were returning to a "Goldilocks" scenario of years past — economic growth, inflation and interest rates not too hot, not too cold, but just right. My retort was that if any type of fairy tale will describe the environment over the next several years, it may be more akin to "Hansel and Gretel," with investors trying to avoid the wicked witch and her oven.

While our view remains constructive on the prospect of further positive equity market returns in 2010, we do not think it will be identical to the post-March period. After last year's vigorous post-March rally, the recent volatility is not unexpected. During the rally, positive sentiment rose

considerably while market volatility fell apace. These factors, although positive, made the market vulnerable to bad news or escalating fears. In recent weeks we have seen a rise in both. While a market correction can arise at almost any point, we believe that the current downdraft will be limited due to the amount of cash that is earning almost nothing.

Despite recent cross currents, key market drivers remain mainly positive. On the earnings front, 2010 corporate profit estimates continue to rise. U.S. and global economic growth persist at a modest pace. As the year unfolds, the interest rate and liquidity environment likely will remain supportive of equity gains. On the other hand, policy initiatives and geopolitical concerns will pose a challenge to the markets. Also, leading indicators for U.S. and global growth likely will become less favorable later in the year, which could negatively impact the markets.

After the March 2009 lows, the winning portfolio decision was to add to riskier assets. Because they had been beaten down so much in the prior collapse, riskier investments

in almost every asset class had the most to gain as markets and the economy began to recover. We do not think that this will continue to be the path to success in 2010. Already investors are showing signs of differentiation in their views of strategies that represent opportunity versus strategies that are fully priced. The recent gain in U.S. currency, as well as the declining attractiveness of U.S. assets in general, has precipitated some of this change.

In a market where the winds of change likely will continue to blow, we think investors will be well served by investments that capitalize on some of these shifts or, at the very least, hold up better during periodic downdrafts. Some of these investments include hedged equity strategies, certain debt strategies that have remaining opportunity and other capabilities that exploit price movements in both directions rather than just on the upside. We also expect that diversification, including multi-manager solutions and broad asset class exposure, will prove helpful in navigating a windswept landscape.

Over the last year or more, we have emphasized the importance of nimbleness in employing diverse investment solutions and more actively and frequently assessing and implementing asset allocation shifts.

Investors asking if we are in a new secular (i.e., long-term) bull market might consider a final bedtime story. This one could be the sequel to *Alice's Adventures in Wonderland*, also known as *Through the Looking-Glass*. In our view, many attributes of the current environment are the mirror image, or exact opposite, of those at the beginning of the last great bull market of 1982. Many elements that led to that bull market were contrary to the headwinds that are blowing in the face of investors today. At that time, inflation, interest rates, taxes and unemployment were high but falling. Policy initiatives were favorable to growth and global trade. Valuations were low. The polar opposite of these dynamics today will likely represent headwinds for investors for quite some time. To be successful, investors will need to lean against the wind when necessary without being blown over. We think success is possible, but it will not be as easy as simply "buy and hold."

The challenge in reading too many fairy tales is that they all end with "happily ever after." Achieving this result in real life will be considerably more challenging and will necessitate adopting different approaches than those that worked in the days of yore.



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