

# Q1 2010 Quarterly Investment Commentary



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Spring is in the air with March Madness, the Masters golf tournament and the beginning of baseball season, at least for those of us who are sports enthusiasts. Warmer weather, longer days and the promise of summer seem to appeal to all of us. At the same time, the remains of El Nino have continued to generate rain into April in areas normally used to sunshine at this time of year. Similar to the weather gradually improving, with periods of rain and cold before moving into summer, global economies are improving in “fits and starts”. Good economic news continues to mix with mediocre data as the global economy finds its way out of recession. We would not be surprised to see markets settle into a “trading range” temporarily pausing for earnings to catch up to one of the historically strongest market recoveries from the market lows of 13 months ago. Our expectation for the balance of the year is for continued slow growth as the U.S. and Euro zone settle into a “new normal” economy with stubbornly higher unemployment and a housing recovery that will take time to emerge. The much talked about “green shoots” haven’t disappeared, but they haven’t bloomed fully either.

We continue to be pleased with the performance of our portfolios. Diversification has provided returns in line with our benchmark indexes even as we have been positioned to protect on the downside with our current overweight in fixed income.

## First Quarter 2010 Market Performance

Index	March	Q1 / YTD
Wilshire REIT Index	10.15%	9.82%
Russell 2000	8.14%	8.85%
MSCI Emerging Markets	8.08%	2.45%
Russell Midcap	7.07%	8.67%
Russell 1000 Value	6.51%	6.79%
MSCI EAFE Equity Index	6.31%	0.94%
S & P 500	6.03%	5.38%
Russell 1000 Growth	5.78%	4.65%
S&P GSCI Index	1.94%	-0.72%
BarCap Aggregate	0.08%	1.68%
30-Day Money Market Yield	0.01%	0.05%
BarCap Global Aggregate	-0.87%	-0.27%
Dow Jones Commodity Index	-1.24%	-5.03%

The markets rose in March as the S&P gained 6.03% to move into positive territory for the Quarter and YTD. All U.S. asset classes, except US Growth, beat the S&P. Large Value turned the tables on Growth after lagging last month, and extended its lead YTD. Developed International was positive by 6.3% and Emerging International rose 8.1%. REITs were the top performing asset class with a 10.2% return, while Commodities lagged, especially the Dow Jones Commodity Index,

which is limited to 30% Energy. U.S. Fixed Income had positive returns, while Foreign Fixed moved to the negative.

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## Greener Shoots?

We began hearing about economic “green shoots” early in 2009 as an economic collapse was averted and signs of stability began to emerge. The first “shoot” emerged when the financial system began to stabilize in early March; the fear that the U.S. government would nationalize some of the largest banks faded at that time. Since then, we have seen the beginnings of a true economic recovery as the Federal Reserve has maintained a very accommodative stance and governments around the globe have poured unprecedented stimulus into their economies. Over the past few months positive economic signs have increased. As we complete this letter, retail sales increased 1.6% in March, the largest gain in four months and higher than analysts had expected. Sales of cars and parts rose 6.7%. Excluding the car sector, all other retail sales rose 0.6%. As “earnings season” kicks off, initial releases have been good as U.S. companies continue to increase both profits and sales; of the initial 180 companies reporting earnings, 86% have exceeded earnings expectations, one of the highest rates exceeding expectations ever. Meanwhile, price inflation continues to be tame, rising by only 0.1% in March; core prices held steady, giving the Federal Reserve continued leeway to keep interest rates at record lows.

All this is positive for the U.S. economy in the near term. We are encouraged by these signs and think this modest recovery here in the U.S. will continue into late this year, or early next year. We expect the Federal Reserve to hold low rates steady for a while, and that it will be late 2010 to early 2011 before the Fed begins to tighten. With the market’s tendency to discount an interpretation of the future, our market concerns are more for late summer to early fall. We have already had a historically strong surge in the markets, as the stock market has risen from an S&P 500 low of below 670 to the March 31 value of 1,180, a 76% rebound. At the same time, we recognize the S&P 500 is still 25% below the all time high from October 2007. We are pleased that the market has rebounded so quickly and appreciate the positive “wealth effect” as rising stock prices reinforce a feeling of improving conditions in consumers. It is this “feedback” loop that helps economies pull out of recessions.

Economic growth in the emerging world is a positive that we factor into our earnings work. We give U.S. companies some credit for the incremental profit growth based upon sales to emerging markets. As an example, GM said recently it sold 230,048 vehicles in China during March of 2010, a 68% gain from a year earlier, compared to sales of 188,011 vehicles in the U.S., which was a rise of 21% from the year previously. GM actually sold more vehicles in China than in the U.S. last month, and this trend is likely to continue. Like GM, many U.S. companies are aggressively expanding in emerging countries, and their success will benefit their reported sales and profits. As for these emerging

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economies themselves, many of these countries are not saddled with high debt levels and should benefit from a rising middle class—a long-term positive that helps support growth in the short run. Many of these countries remain highly competitive in a number of export industries while others have commodity-driven economies that benefit from growing worldwide demand. Generally these parts of the world economy are not immune to economic weakness in the developed world, but they are potentially more resilient.

### **What Could Go Wrong?**

Despite all these positive factors, there are continued major challenges ahead for the U.S. and other developed world economies. Our major concerns are stubbornly high unemployment, housing prices with an impending increase in the inventory of foreclosed homes, and the massive Federal deficit with unfunded Federal and State liabilities such as Social Security and government pensions. Unemployment is definitely of concern for us. The economy finally started to create jobs in March, but almost one in 10 Americans is still without a job. In fact, 44% of the unemployed have been without a job for six months or more. High unemployment also contributes to our 2nd concern: housing. As the U.S. government and banks struggle with loan modifications, many already foreclosed homes remain in the hands of banks and are scheduled to hit the market soon. Additionally, nearly eight million households are behind on mortgage payments or already in the foreclosure process. Until housing bottoms consistently and begins to rise, the second leg of a “wealth effect” will not help offset the pain we’ve been experiencing since August 2007.

As we have previously written, government finances are also a trouble spot. While the political flexibility of the U.S. constitution has enabled us to confront many past difficulties, make important changes, and then move on to improve the lives of Americans, we have not previously faced the situation of our politicians needing to rescind on their promises to a majority of our fellow citizens. As historian Alexander Tyler once wrote, “A democracy can only exist until the voters discover that they can vote themselves money from the public treasury. From that moment on, the majority always votes for the candidates promising the most money from the public treasury.” While Mr. Tyler probably overstates the impacts on our governmental system, what is happening in Greece right now is indicative of a country that goes along with large government deficits and unfunded government pension promises that inevitably need to be changed. As a result, Greece has seen strikes, social unrest, and reduced economic output from its people, while investors have forced the government to change tax collection, reduce government worker salaries and pensions, and cut other government spending.

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Both the Republicans and the Democrats have been culpable on this count in the U.S., and the layoffs in local and state governments around the country are only the beginning. While our famous flexibility could come to the rescue, our current partisan bickering is simply putting off the inevitable problems into the future. Social Security is running a deficit this year, five years earlier than anticipated. Government pensions at all levels are massively underfunded. The massive growth in the numbers of elderly in the U.S. is simply a matter of time and demographics, not a question of if it will happen. Thus, the problems of funding Social Security and Medicare will simply grow. The inability of our people and their elected officials to confront these problems portends a painful economic time coming at some point.

### **What about Portfolios?**

In our earlier commentaries and last quarterly letter we outlined our rationale for slower than normal global growth over the upcoming five year horizon. The markets did well in Q1 as the U.S. economy began to show the traditional early signs of a recovery. However, much of the recent economic strength has been helped by stimulus spending and increased manufacturing to begin rebuilding retailers' inventories. Other issues include huge amounts of commercial real estate debt coming due and possible high inflation down the road from deficit spending. In light of last year's market gains and the challenges ahead, we think it prudent to remain vigilant to potential downside risk. The current recovery is supportive of near term growth, and it may well be that the structural problems we face may get addressed. But enough risks are present that we remain in a conservative posture, cognizant of the possible risks, yet invested in a diversified manner that provides good returns and a bit of defense.

We believe that with continued strong growth in emerging markets, along with moderate growth here at home and in other developed nations, there are opportunities for our managers to excel. We use a combination of active and passive managers in our portfolios. The passive managers provide a return equal to the indexes they mirror, minus their low fees. Active managers seek to beat their indexes over time and charge a higher fee to compensate them for research and profit. We think that conditions today are very good for active managers. When markets rise as much and as fast as they have over the past year, many good and not so good companies go along for the ride, as the "tide raises all boats". Many of the active managers we speak with say they are still able to find compelling companies at reasonable prices. At some point (we think around now), not all companies will continue to do well and wise company investments will generate returns in excess of the broader indexes. We expect that the time for those wise investments to outperform the markets is at hand.