Crisis of Confidence, How to Survive and Succeed in a Today's Volatile Economic Environment

What is it going to take to bring investors confidently back into the equity markets? One answer may be a restored feeling of assurance that the hyper volatility is now behind us. That seems unlikely; however, lower volatility alone may not be enough of a catalyst for spooked investors.

Historically, investors run for the exits when markets decline, and often do not return in time for the rebound. That was the case in 2009, and the scenario continues in 2010. Through the end of Q1 2010, $91 billion has flowed into bond funds, while only $29 billion has flowed into equity funds.[1] Given recent dramatic swings in global stock markets, it is understandable that many investors could no longer stand the pain of "staying the course". It is commonly understood in money management circles, however, that if more portfolios were positioned properly, i.e. proper asset allocation, the pain of recent market declines may have been reduced.

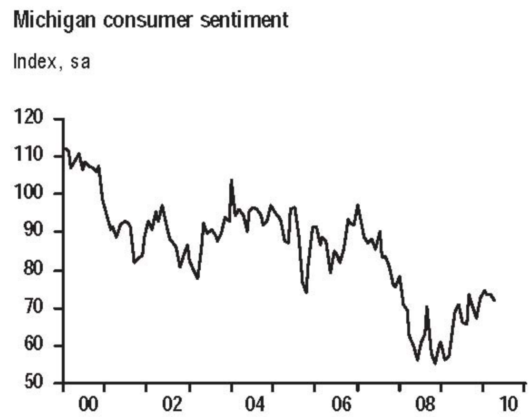
Another area of recent investor concern is the US real estate market. The largest component of most Americans' balance sheet is their home. The American consumer accounts for approximately 70% of the US economy. Diminishing home values over the last 36 months has dramatically affected US consumer confidence, which in turn controls spending habits. A meaningful acceleration of consumer spending can only occur when we see some stabilization in housing values. The good news is that there are signs that housing markets in many US metropolitan centers are, indeed, firming up.

We do have some other positives to consider:

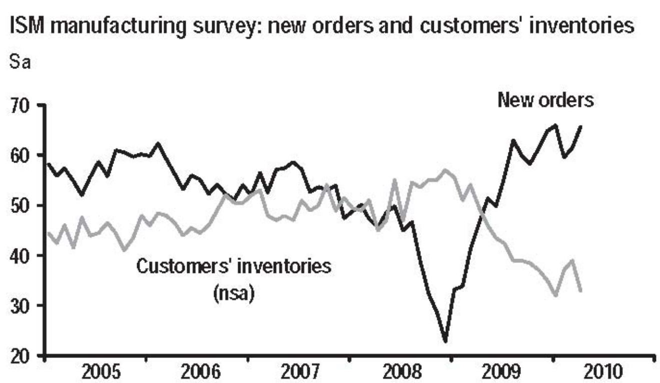
- The US economy has clearly rebounded off of its worst recessionary levels, as GDP has grown 5.6% in Q4 2009 and 3.2% in Q1 2010.
- US Consumer sentiment has improved from its lows in late 2008 and is trending positive again.[2]

[1] Investment Company Institute

[2] Michigan Consumer Sentiment Data – University of Michigan, Surveys of Consumers



- Corporate earnings have trended towards surprising on the upside, and many fundamentalists believe that valuations are relatively attractive at current levels.
- Interest rates are historically low, and are likely to remain as such for some time to come.
- Although there has been an obvious reluctance on the part of banks to lend, there appears to be a recent thawing in corporate lending activity.
- There is growing momentum in US manufacturing, as referenced by recent ISM Manufacturing data publications.



In today's market environment it is critical to employ portfolio strategies that meet investors' long term needs. Realistic standards for risk and return parameters must be established and completely understood. Portfolio composition for maximum efficiency and diversification should be priority one.

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Asset allocation continues to be the most critical component of investment portfolio construction. As 2008 demonstrated, there may be times when all assets become highly correlated, and asset allocation appears to falter, but looking back on that timeframe now, clearly demonstrates that adherence to a "stay the course" strategy will succeed in reducing volatility in the long run and smooth out returns over time. When portfolios stay diversified and stay invested, investors reap the benefits of market rebounds after surviving the crisis-induced declines.

Many investors have read about the "Lost Decade". In fact if you had purchased the S&P 500 index in January of 2000, and did not purchase anything else for the next 10 years, you would have had a negative total return of -0.95%. Investors (in the stock market) during the "Lost Decade began the period alarmingly close to the worst terror attack in our nation's history, and ended it with the worst financial crisis since the Great Depression. Food for thought…

Those who remained disciplined and diversified, most likely had positive returns during the last ten years, despite all that happened. Granted, there were periods of extremely high volatility and anxiety, however, following the plan of a well diversified portfolio paid off. Incorporating fixed income investments and loosely correlated, alternative investments, such as managed futures and commodities, blessedly provided investors with buoyancy and positive returns during equity bear markets.

Asset allocation modeling is not designed for market timing. Rather, it is designed for the orchestration of multiple strategies with different risk/return characteristics, that when combined, help investors meet specific goals over reasonable longer-term time horizons.

Asset allocation is also not an exact science, and it has lost a bit of its shine lately. There never was a foolproof formula that could predict future market gyrations; there was fundamental allocation modeling – the most utilized and time-tested investment methodology that industry professionals had. Professionals know that the best methodologies rely on the fundamentals, and don't involve placing big bets on short-term market movements.

Long-term portfolio structuring strategies have proven to provide more consistent returns than applying tactics alone. While tactical overlay and shifting of assets and cash positions in accordance with clear economic trends is important, it loses effectiveness without the appropriate asset allocation foundation. Diversification amongst historically, relatively low-correlated asset classes, and matching portfolio risk characteristics to specific time horizons, has proven to be the most consistent method of building portfolio efficiency. Now if we could just get all those spooked investors out there to buy into it…

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