

# MARKET REVIEW |

DOMESTIC EQUITY  
INTERNATIONAL EQUITY  
FIXED INCOME

Second Quarter 2010

## **DOMESTIC EQUITY MARKET**

Investors compiling their 2010 wish lists last holiday season undoubtedly ranked strong growth in corporate profits from their investments and continued low interest rates at the top. As the first quarter unfolded, their wishes began to come true. Earnings for the S&P 500<sup>®</sup> increased more than 50% in the quarter, while estimates for the second quarter and the year were increasing. Throughout the first quarter, interest rates remained historically low as overnight rates held near 0% while the yield on the 10-year Treasury fluctuated between 3.5% and 3.8%. Equity returns responded with large-capitalization stocks increasing more than 5% and small-cap stocks advancing nearly 9%.

While the news flow from Corporate America in the second quarter continued to demonstrate a recovery in revenues and earnings, other issues took center stage with investors. The financial crisis was clearly not over. As exemplified by the situation in Greece, several European countries still struggled with severe budget deficit problems that kept the world financial system on edge. The market, it appeared, had moved from its sub-prime mortgage crisis to a sub-prime sovereign crisis.

As investors were digesting these developments abroad, U.S. macro-economic data did not provide signs of encouragement. Initial unemployment claims remained stubbornly high and the growth in payroll jobs was less than expected. Growth in gross domestic product slowed from 5.6% in the fourth quarter of 2009 to 2.7% in the first quarter of 2010. While this is in line with the economy's long-term potential, it is significantly below the rate expected in periods that follow a severe economic decline such as the one experienced in 2008-2009. As a result, talk of the possibility of a double-dip recession surfaced, with investors concerned that policymakers were handcuffed by rock bottom interest rates and the federal government's large budget deficit. Additionally, activism in Washington, it seems, only discouraged hiring and investment. The net effect of this uncertain environment, or at least investors' perception of its uncertainty, was a retreat by investors from risk toward safety. Equity returns posted double-digit declines both in the U.S. and in foreign markets. The S&P 500<sup>®</sup> Index, a measure of large-cap stocks, declined 11.43%, small-cap stocks as represented by the Russell 2000<sup>®</sup> Index declined 9.92% and the MSCI EAFE Index of international stocks declined 13.78%.

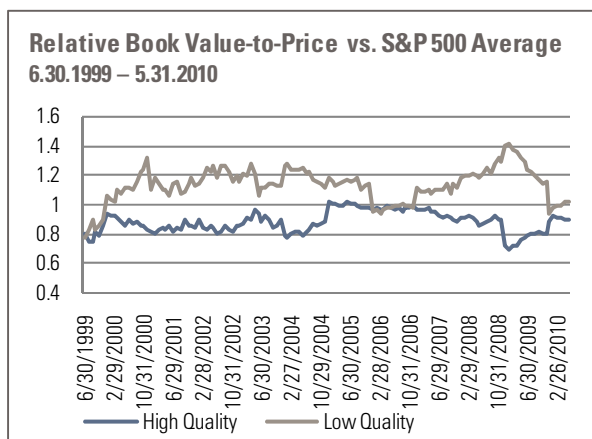
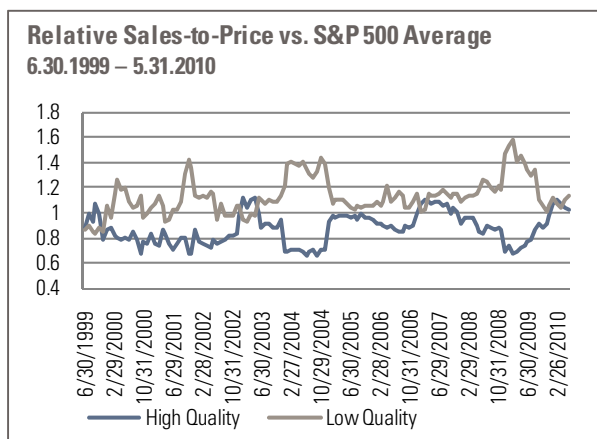
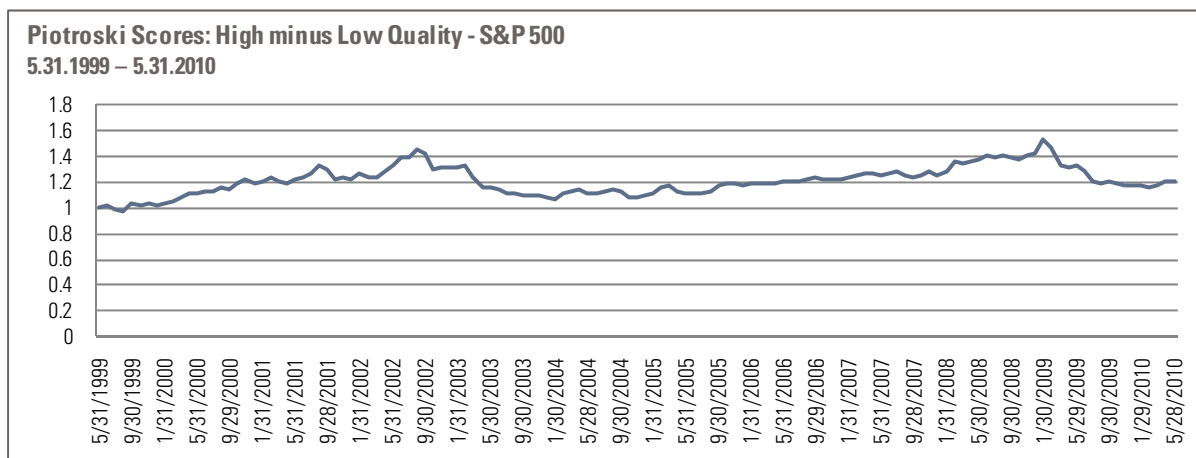
Despite the challenging macro-economic news, the financial condition of Corporate America is surprisingly healthy. Cash balances and long-term debt are at historically strong levels driven by a high degree of free cash flow. Earnings growth, while decelerating, is expected to remain positive with double-digit growth rates through 2011. The number of companies raising dividends is increasing compared to 2009 along with the number of stock repurchase announcements. This is another indication of strong corporate cash flow and also the increasing confidence of management in future business conditions. Under more ordinary circumstances these financial metrics, combined with today's reasonable valuation levels, ought to support an optimistic market outlook.

While the quality of a company is unquestionably important to investors, high quality is not all that an investor seeks. Unlike in the case of consumer purchases, where people generally are reluctant to spend their hard-earned dollars on low quality items, there are times when investors actively seek and are rewarded for buying low quality stocks. Research has shown that stocks of higher quality companies have historically performed best when earnings growth is under pressure and market volatility is high. Low quality has done well when earnings are booming and volatility is low, as has been the case in the current market recovery. Since the market bottom in the first quarter of 2009, lower quality issues have been the market's best performers. As the investment environment changes, the factors driving these results should shift and returns should again favor quality. Some of that shift became evident in the second quarter.

While we still anticipate continued growth, we expect the rate of change, and the rate of earnings growth, to decelerate. As this occurs, quarterly comparisons tend to become more difficult as future results must be compared to earnings that already reflect a post-recession recovery in profitability and companies must rely on organic growth to post improved results. Under these circumstances, we generally expect earnings growth to become more and more scarce.

Given the number and intractability of the economic and political problems facing the U.S. and global economies, investors are likely to continue to experience periods of increased uncertainty as events unfold. As a consequence, market volatility may very well remain elevated and be subject to periodic spikes associated with investor reactions to a series of crises.

When asking what opportunities this kind of environment presents, it is helpful to consider the fact that at the same time that the market appears to be moving toward favoring quality, quality is historically relatively cheap. A look at the recent historical differentials between the valuation of high quality and low quality companies reveals that quality is priced relatively inexpensively. On both a sales-to-price and book value-to-price basis, the difference between high quality and low quality is historically narrow. In other words, while the investment environment appears to be starting to favor quality, that sentiment does not seem to be factored into price.



Source: FactSet Fundamentals

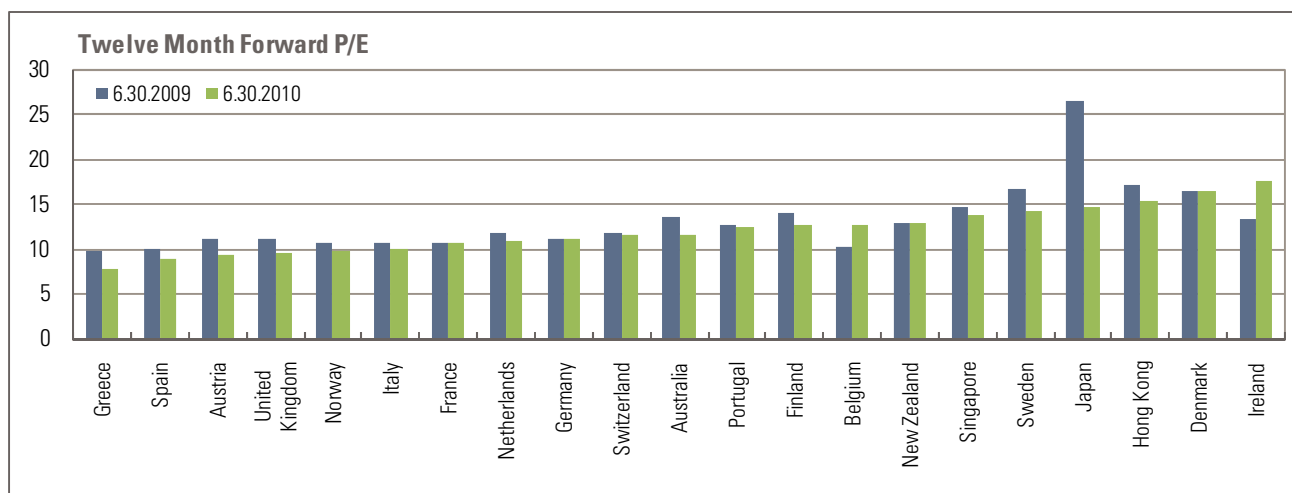
Is quality poised to outperform?

Recent data both in the U.S. (housing, employment) and internationally (sovereign debt concerns) has brought a heightened awareness to the fragile nature of the global recovery. With the prospect of market volatility remaining elevated, earnings growth becoming increasingly scarce, and the valuations of high quality stocks now looking more attractive given the extended period of strength with regards to the relative price trends of low quality versus high quality stocks, the current market environment augurs well for both high quality stocks and investment managers that have proven expertise in astute stock selection.

## **INTERNATIONAL EQUITY MARKET**

Markets around the world fell significantly in the second quarter driven by a jittery global investment community that perceived slowing global growth. Investors moved to the sidelines in anticipation of another wave of selling based on disappointing news ranging from Europe's fiscal plight to tighter financial regulation in the U.S. and slowing growth in China as well as other developing economies. U.S. Treasuries as well as Japanese government bonds experienced accelerated inflows based on yen strength as currency investors shunned eurodollars. Returns in May for MSCI EAFE Indices, both large and small, were within the top 10 worst one-month returns in the history of each Index, another reflection of investor angst. One by one these broad headlines created an outlook with a very wide range of outcomes rather than a single potential theme. We saw this right down to the eurozone where the single currency area faces economic, institutional, and political challenges. Predictions made for some time now regarding the pitfalls of governmental poor spending habits in Europe and the austerity measures that would result are now coming true. What's unfolding there serves as a precursor to other economies and governments that deficit spend. Sooner or later the deficit spending has to slow and the pile of debt has to be repaid.

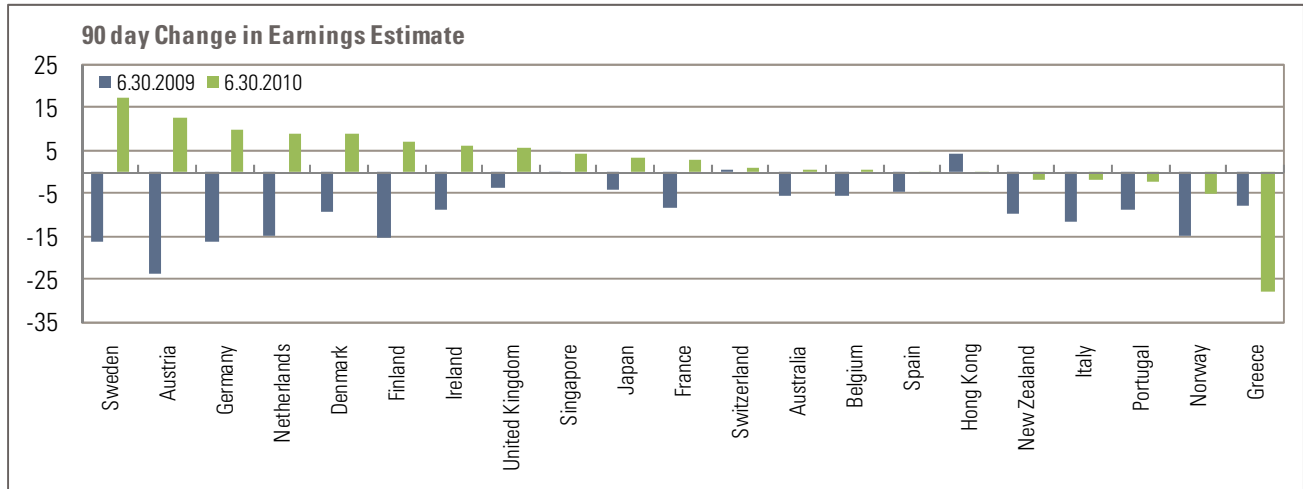
Europe's stronger economies, such as Germany, France, and Netherlands, along with the Europe Central Bank (ECB) responded late to the sovereign crisis but finally took aim at providing a liquidity facility to bolster countries struggling to access the capital markets. Regardless of how long that support lasts, the objective is clearly to buy time for countries to make fiscal adjustments and to try to improve their debt-to-GDP ratios through growth, which could ignite inflationary pressures. Much like the U.S. quantitative easing through open market purchase of corporate and mortgage bonds, the ECB has reluctantly used the facility to purchase government debt weighted more toward Greece and other deteriorating countries whose costs of borrowing have increased quite dramatically. The European region represents nearly half of the MSCI EAFE Index market capitalization and deserves attention on a country-by-country basis as it weighs heavily on the direction of international equity returns. While certain eurozone countries, large and small, have their defined problems, there are opportunities throughout this region in light of the overhang. While we may underweight certain countries in our search for quality stocks, prior weakness in recent months has created an attractive opportunity set within the countries that we invest.



Source: Thompson, IBES

Over the last twelve months through June 30, 2010, international equity markets, in aggregate, were up 5.9% and valuations stayed reasonable for large and midsized companies and are actually more attractive since the sell-off in May. Not surprisingly, the countries with the lowest forward P/E's are the infamous PIGS (Portugal, Italy, Greece, and Spain) of Europe. With the exception of Portugal, stocks in the countries of Greece, Spain, and Italy have an aggregate P/E ratio under 10 times next year's forecast earnings. Although the countries have legitimate fiscal problems, there are companies that have been unnecessarily tainted by these problems that can translate into undervalued opportunities. Asia and Pacific Rim countries have been experiencing moderate growth and valuations in these countries have also become a bit more attractive over the last year given general risk aversion. In this type of environment, differentiating between earnings growth and *quality* earnings growth makes a big difference in the sustainability of excess returns. The current investing environment is geared more

toward the disciplined stockpicker. Our bottom up focus seeks companies with higher quality business momentum at a price that may not yet reflect an improving environment for the company’s potential. Peripheral countries of Europe come to mind such as Denmark, Sweden, Finland, and Austria whose stocks have suffered "guilt by association" with the general malaise throughout Europe. Although some of these countries never joined the European Union, they nonetheless are impacted -- positively or negatively -- by events that occur in the eurozone.



Source: Thompson, IBES

There has been an extraordinary turnaround in earnings expectations over the last year. The chart above graphs the 90-day change in analysts’ earnings estimates for the next 12 months by country. For example, by the end of the second quarter of 2009, companies in Sweden had their earnings estimates for the following one year cut by 16.3%. In other words, from March 31, 2009 to June 30, 2009 analysts following stocks in Sweden turned fairly negative and reduced their 12-month outlook for earnings by 16.3%. A year later, at the end of the second quarter ending June 30, 2010, analysts' estimates over the previous 90 days had increased by 17.5% for the next 12 months. Stocks in Sweden were up nearly 30% over the last year relative to the MSCI EAFE return of 5.9%. That dramatic change in sentiment and actual earnings turnaround had a very positive impact on stock prices in Sweden. The sentiment has been quite dramatic on the upside in several other countries and more precisely on the downside with Greece and, to a lesser extent, Italy and Portugal. Stock prices in those countries have been abysmal over the last 12 months through June 30, 2010.

During the last quarter we have seen improving trends in top line growth in the companies we analyze. While bottom line improvement was mainly due to cost cutting and austerity measures a year ago, we see improving trends in the quality of earnings that are being generated from new market share and general increased economic activity. As can be seen in the last two charts, there are certain countries whose companies have become more attractive from an earnings momentum perspective and on a valuation basis. We won’t shy away from a troubled country; in fact, we continue to look for opportunities, particularly from companies that derive top line growth more from global rather than local sources. This is truly a stockpicker’s market and our discipline points us in the direction of companies that exhibit under-appreciated business momentum. A flight from risk kicks up a lot of dust and the macro events that underpin the uncertainty often creates a widening of the disparity between valuation and quality, which in turn provides an increased opportunity set at the security level. It may be unsettling to look back but the horizon looks promising.

**FIXED INCOME MARKET**

The increasing appetite for risk displayed by bond investors over the past several quarters reversed course in the recent second quarter as concerns over sovereign risk escalated, questions surrounding the strength of the economic recovery emerged, and the outcome of the financial regulatory overhaul loomed over the market. Fears of a default by Greece on its government debt as well as the potential need for other Southern European countries to refinance large amounts of debt in the coming quarters prompted the European Union, the International Monetary Fund, and the European Central Bank to create a €750 billion support program that will effectively cover the financing needs of Greece, Portugal, Italy, Ireland and Spain for the

next few years, if necessary. As a result, U.S. Treasury yields declined and the dollar strengthened versus the Euro as investors sought a safe haven. The economic impacts of the stronger dollar -- as well as the potential for slower growth in Europe given the abundance of austerity programs that will be needed over the next several years to tackle the outsized budget deficits -- remain to be seen, however, one could reasonably expect dampened prospects for global growth. Additionally, one of the largest pieces of regulatory reform to affect the financial services industry was approved by the House of Representatives and awaits a final vote by the full Senate. While the primary objective of this legislation is to prevent a future crisis such as that witnessed in 2008, investors remain cautious as to its future impact on banks' profitability, permitted business activities, capital requirements, and general willingness to lend under the new rules.

The increase in volatility and uncertainty associated with these events led to a flight to quality in the bond market during the second quarter, driving the benchmark 10-year Treasury yield to its lowest level in over a year, ending the quarter at 2.95%. In sharp contrast to the past several quarters, Treasury securities outperformed most investment grade sectors, most notably corporate bonds issued by financial companies. To further underscore the defensive nature of corporate bond investors, bonds issued by utility companies posted the strongest returns in the corporate sector and marginally outperformed Treasuries. Both commercial mortgage-backed securities and asset-backed securities -- two of last year's top-performing sectors -- lagged the performance of agency mortgage-backed bonds within the securitized sectors. This increased risk aversion, as well as the absence of any signs of inflationary pressures, led to a flattening of the yield curve during the quarter as the spread between the 2-year and 10-year Treasury decreased to 233 basis points from 279.

Looking forward to the third quarter, we expect to see continued volatility in the bond market as investors weigh the impact of European austerity programs on global growth and, more importantly, investors' confidence in the U.S. recovery. While the manufacturing sector appears to be sustaining the current recovery, recent data on housing, retail sales, and employment have been softer and bear watching closely. At the June meeting of the Federal Reserve's Federal Open Market Committee (FOMC) a more cautious tone was noticeable as the committee observed "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad." As a result of this more cautious view, the FOMC reiterated its current policy of "exceptionally low levels of the federal funds rate for an extended period." In our view, the combination of low interest rates, the absence of inflationary pressures, stable commodity prices and lean inventories should promote moderate, yet choppy economic growth over the near term.



All data is as of 6.30.10 unless otherwise noted.

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