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# Slaying the Giant

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JAG Advisors Large Cap Growth

Equity Market Overview: September 2009



# The Giant of Pessimism

“The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism.  
This new error is born not an infant, but a giant.”

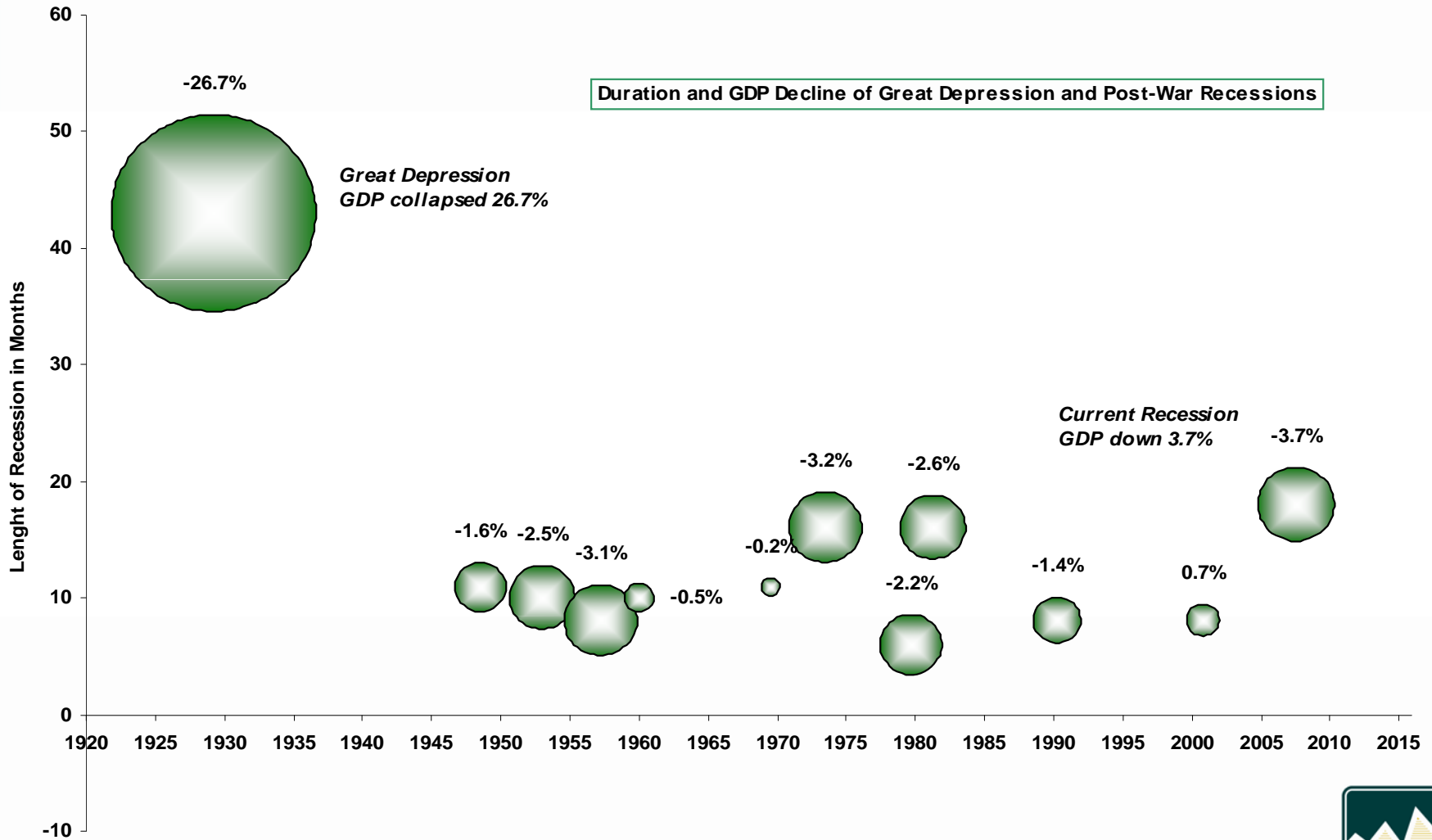
- *Arthur C. Pigou*

- Despite historically strong rally since March 2009, many investors are still pessimistic
  - Crash of 2008 + Great Recession of 2008/2009 = Death of Optimism
  - Investors are confused by the disconnect between equity market strength and current economic conditions
    - Unemployment/underemployment still ticking up
    - Consumer spending yet to recover
    - Weak dollar
    - Looming tax increases
    - Astronomical deficits
    - Massive new entitlements on the horizon
- ...But the markets are *always* disconnected from current conditions!
  - Best equity market performance often has come *in advance* of positive developments
    - 1942: Economy still mired in aftermath of recession, Allies losing war...
    - 1975: Inflation heating up, oil shocks, Watergate still fresh, Vietnam debacle...
    - 1982: Inflation and unemployment still high, Cold War getting warmer...
    - 2009: *Unemployment, deleveraging, Great Recession effects linger...*
- Contrary to intuition, there are numerous reasons to be *optimistic* about U.S. equities



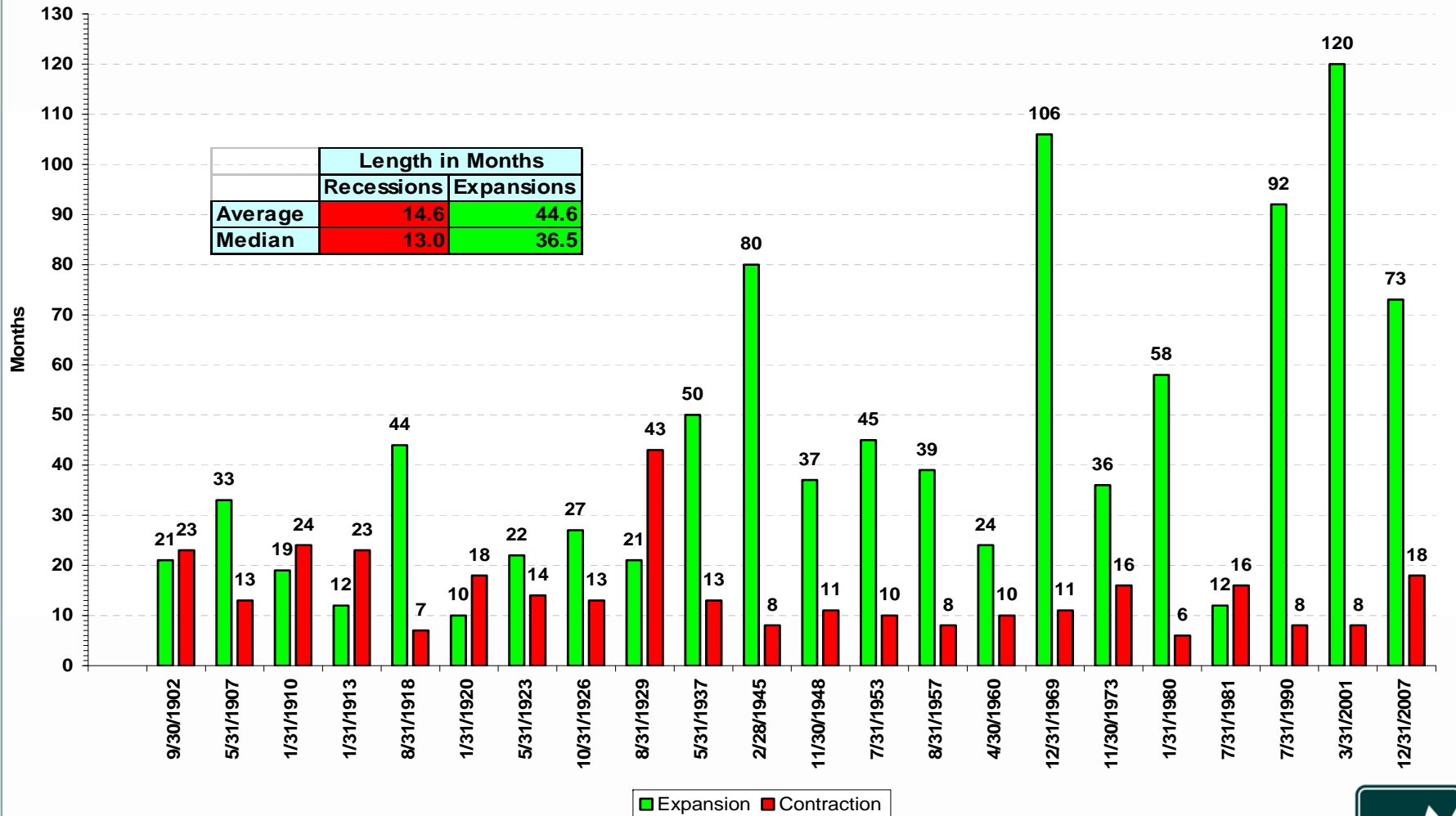
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# Great Depression Still The Worst



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# Average Expansion 3x As Long As Average Recession



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# Credit Markets Are Key to Equity Outlook

- Credit spreads provide insight into market's overall appetite for risk
  - Top of capital structure (bonds) must function more normally *before* equities can post a sustained rally
  - Equities (common stocks) tend to struggle when risk appetite falls (i.e. when credit spreads rise)
  - Conversely, when risk appetite increases (i.e. credit spreads tighten), equities tend to generate outsized gains
- The bad news...
  - Credit spreads are still at recessionary levels
- The good news...
  - Spreads have tightened dramatically since early/mid-December
  - Spread levels generally at or near post-Lehman lows
  - Strong credit market bodes well for equities



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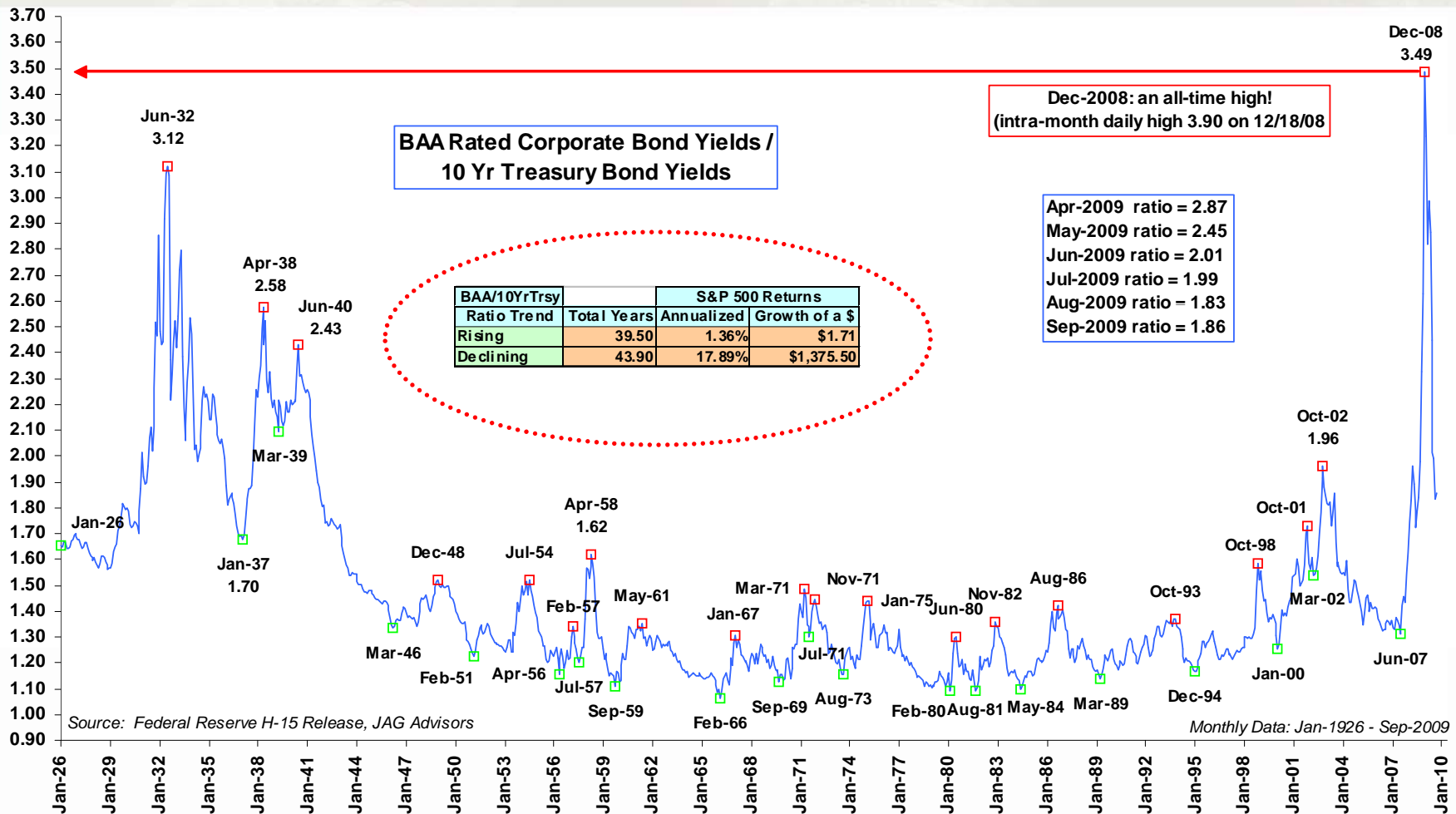
# Credit Market Improvement Bodes Well for Stocks

- Credit led equities on the way down...
  - Spreads began blowing out in 3q 2007 and peaked in 4q 2009
- Credit is now leading equities on the way up...
  - Credit spreads have recaptured pre-Lehman levels
  - ...But equities are still *below* September 2008 levels
  - S&P 500 was above 1250 just prior to Lehman's collapse
  - S&P 500 on 9/30/09: 1060
  - S&P 500 gain needed to recapture Lehman losses = 18%+
- And this has always been the case...
  - Annualized returns of S&P 500 since 1926 during periods of spread *tightening* = 17.89%
  - Annualized returns of S&P 500 since 1926 during periods of spread *widening* = 1.36%
  - Spread ratios remain *above* levels following Long-Term Capital crisis (1998) and 9/11 (2001)
  - We expect further normalization in spreads in 2010... Which could support further equity gains



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# Declining Yield Ratios A Plus For Stocks



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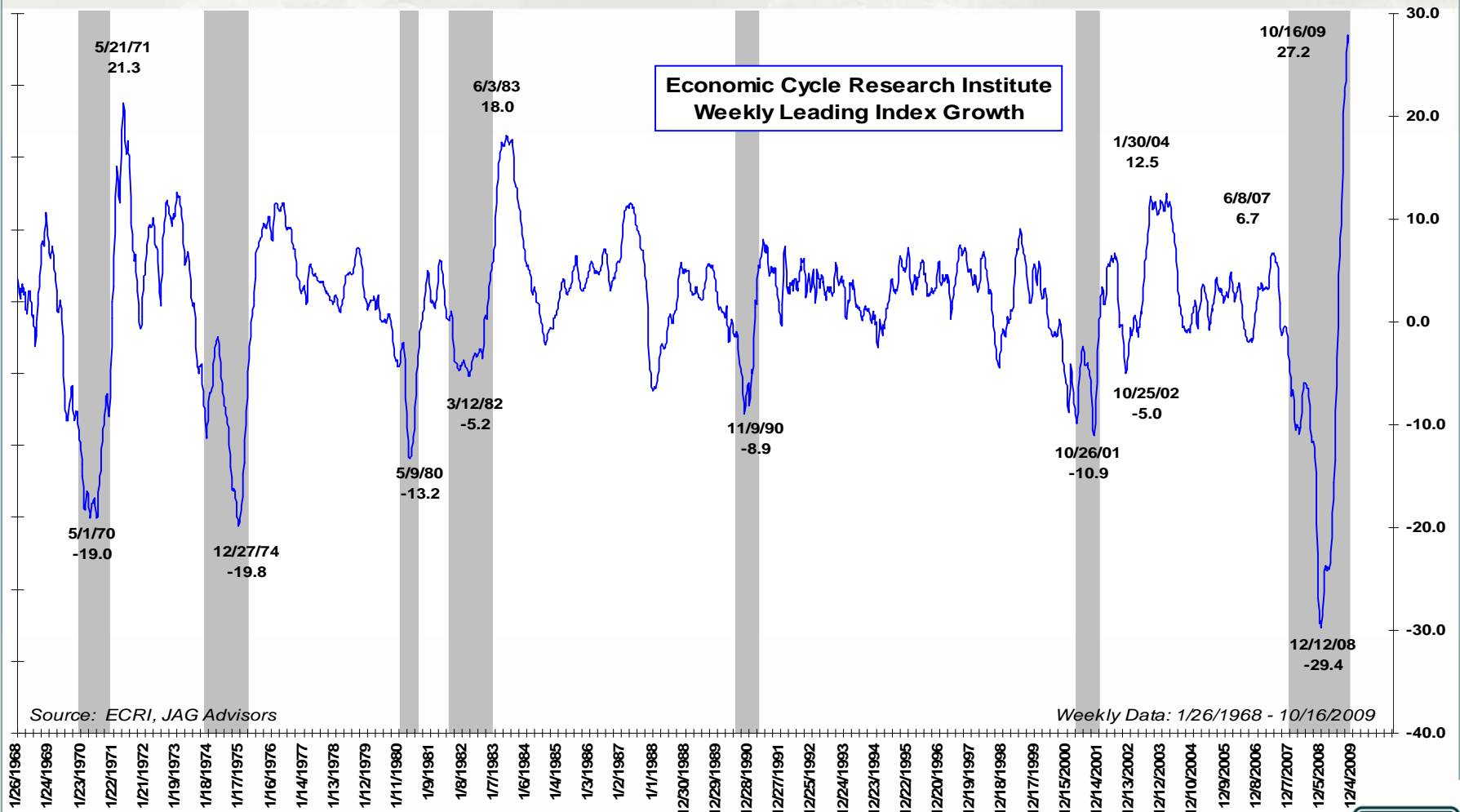
# Economic Recovery is Blossoming

- Economic collapse of 2008 was almost unprecedented
  - Worldwide economic “stroke” put us on the precipice of “Depression 2.0”
  - Even though depression was averted, we still experienced the Great Recession
- However, the speed and depth of the crisis sowed the seeds of recovery
  - Recovery cycle is on a much-faster recovery than expected
  - Visibility beyond 2q 2010 is limited, but...
  - ...All systems currently “go” for recovery into early/mid-2010
- ECRI Weekly Leading Index
  - ECRI is an independent research shop with a great track record
  - Weekly Leading Index is at 40+ year highs
- Jobless Claims & Consumer Sentiment
  - Jobs will be a problem well into 2010 and 2011, but new claims are falling
  - Unemployment/Consumer Sentiment data are *not* good predictors of future stock gains
- Commodities
  - Most important commodity prices have increased meaningfully since March 2009
  - Chinese stockpiling *could* be a contributor, as could inventory re-stocking
- (Even) Real Estate is bottoming...
  - Probable generational low in new housing starts
  - Homes affordability should provide key support going forward



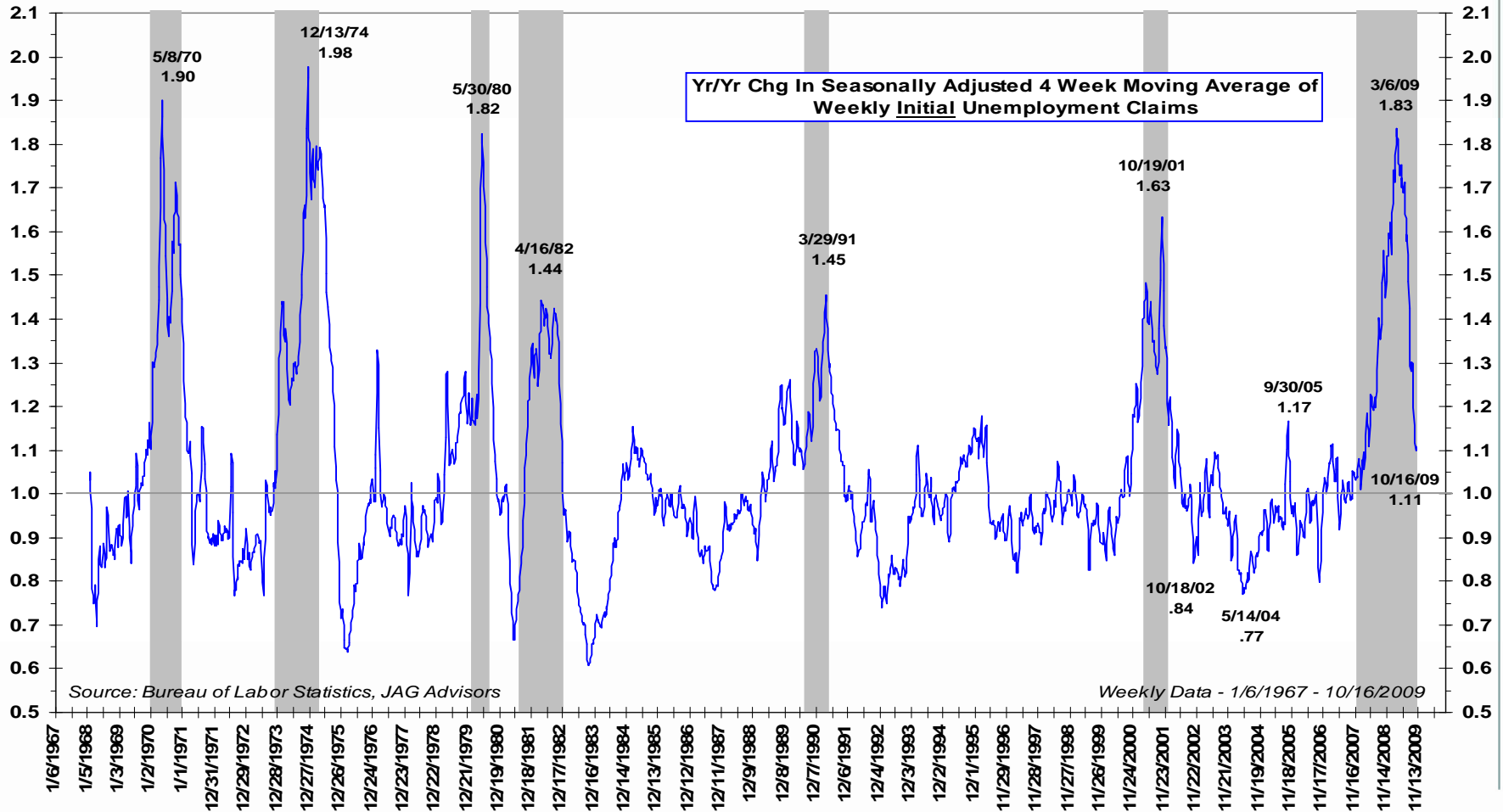
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# ECRI Leading Indicators Strongest in 40+ Years



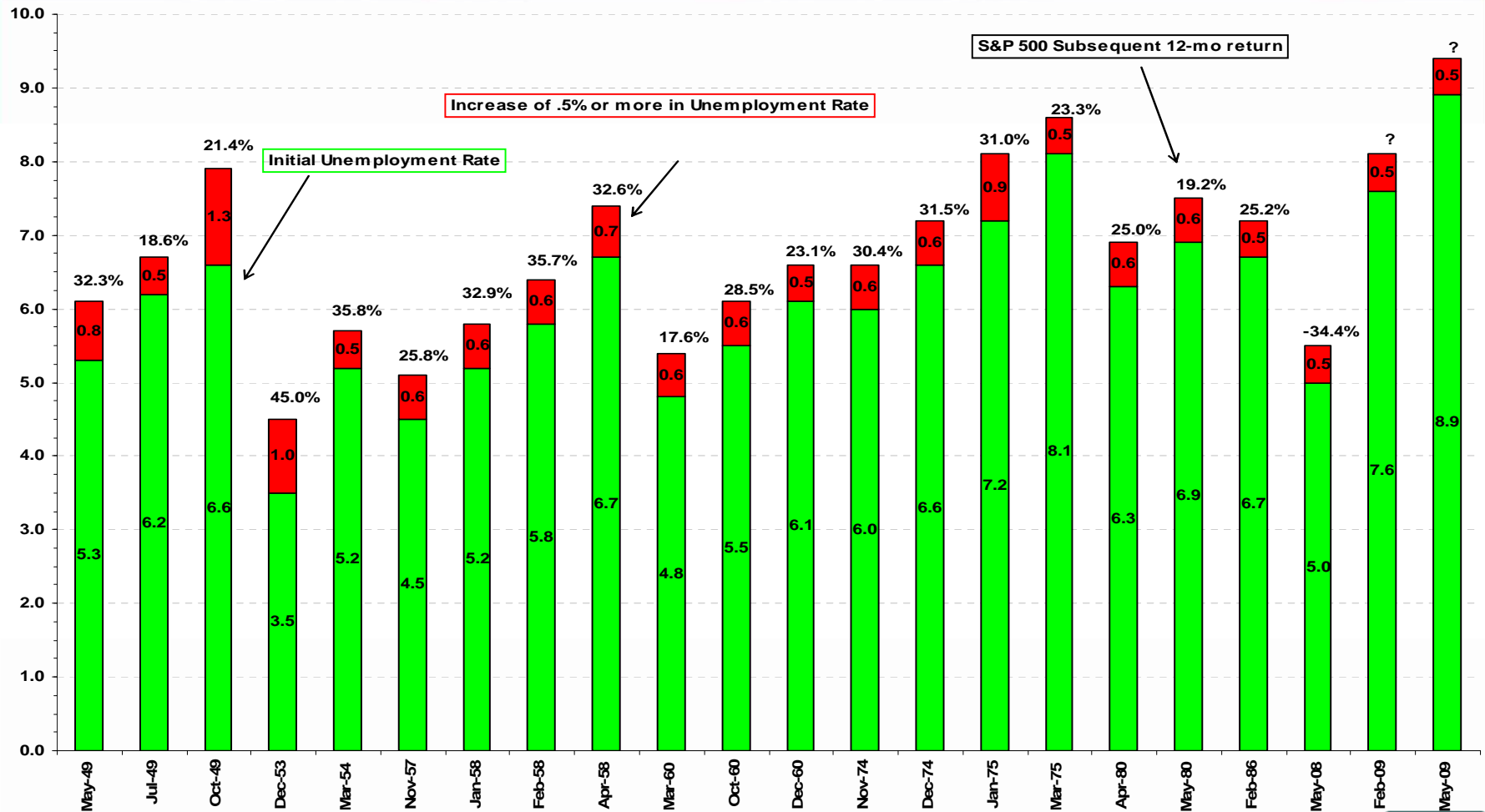
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# Jobless Claims Falling



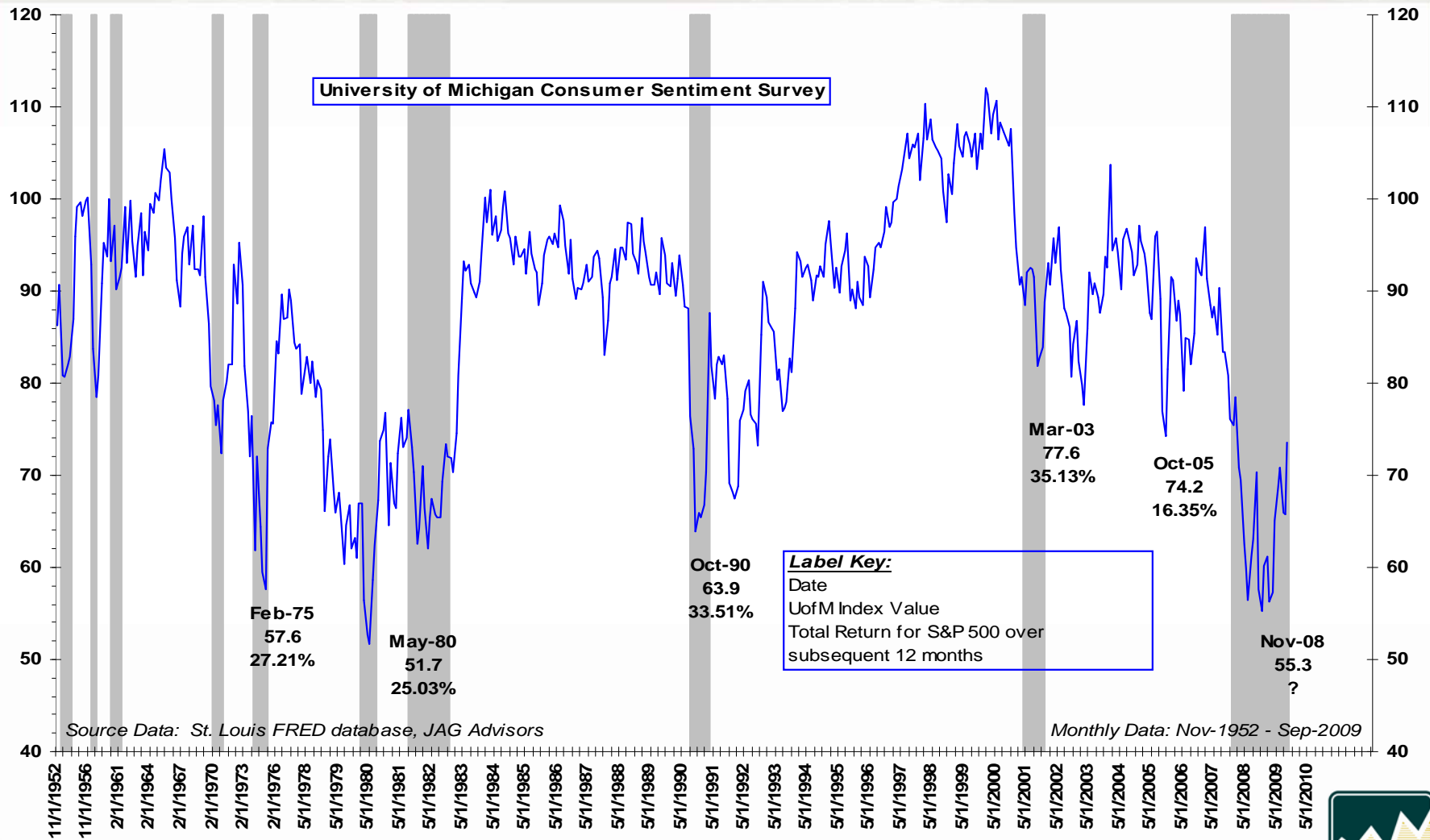
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# Historically Unemployment Spikes Not Bad For Stocks



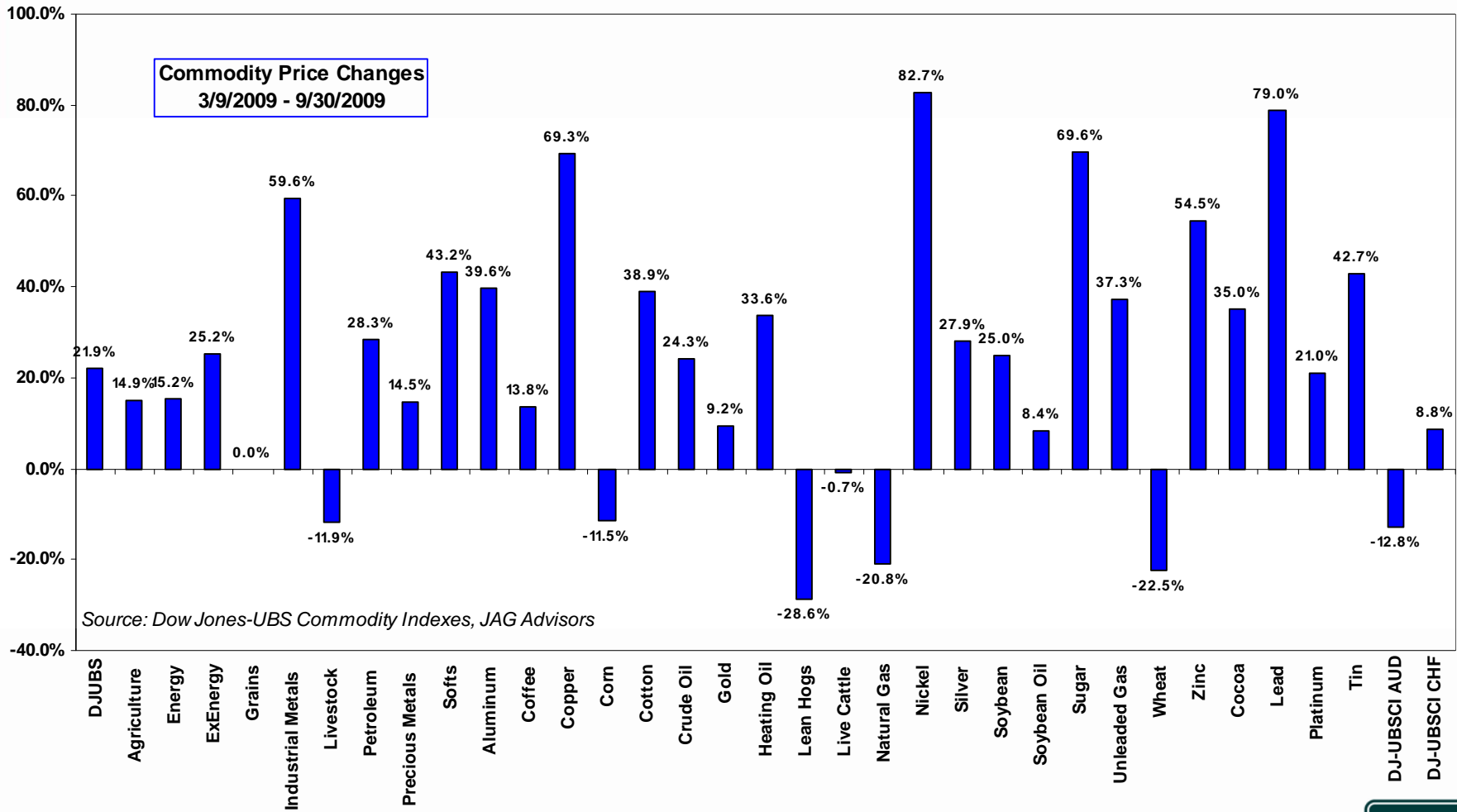
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# Stocks Soar on Sour Sentiment



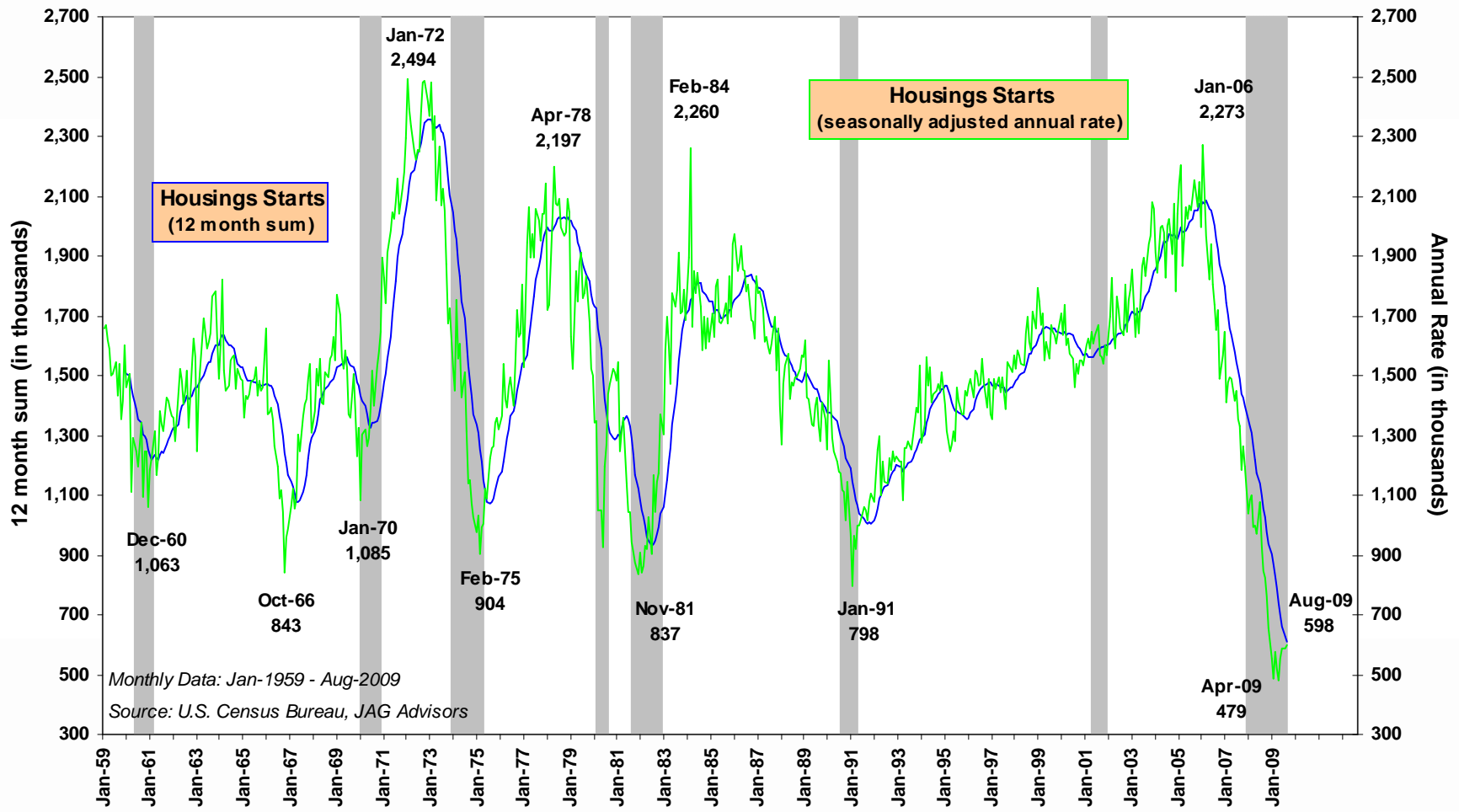
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# Signs of Life in Commodity Prices



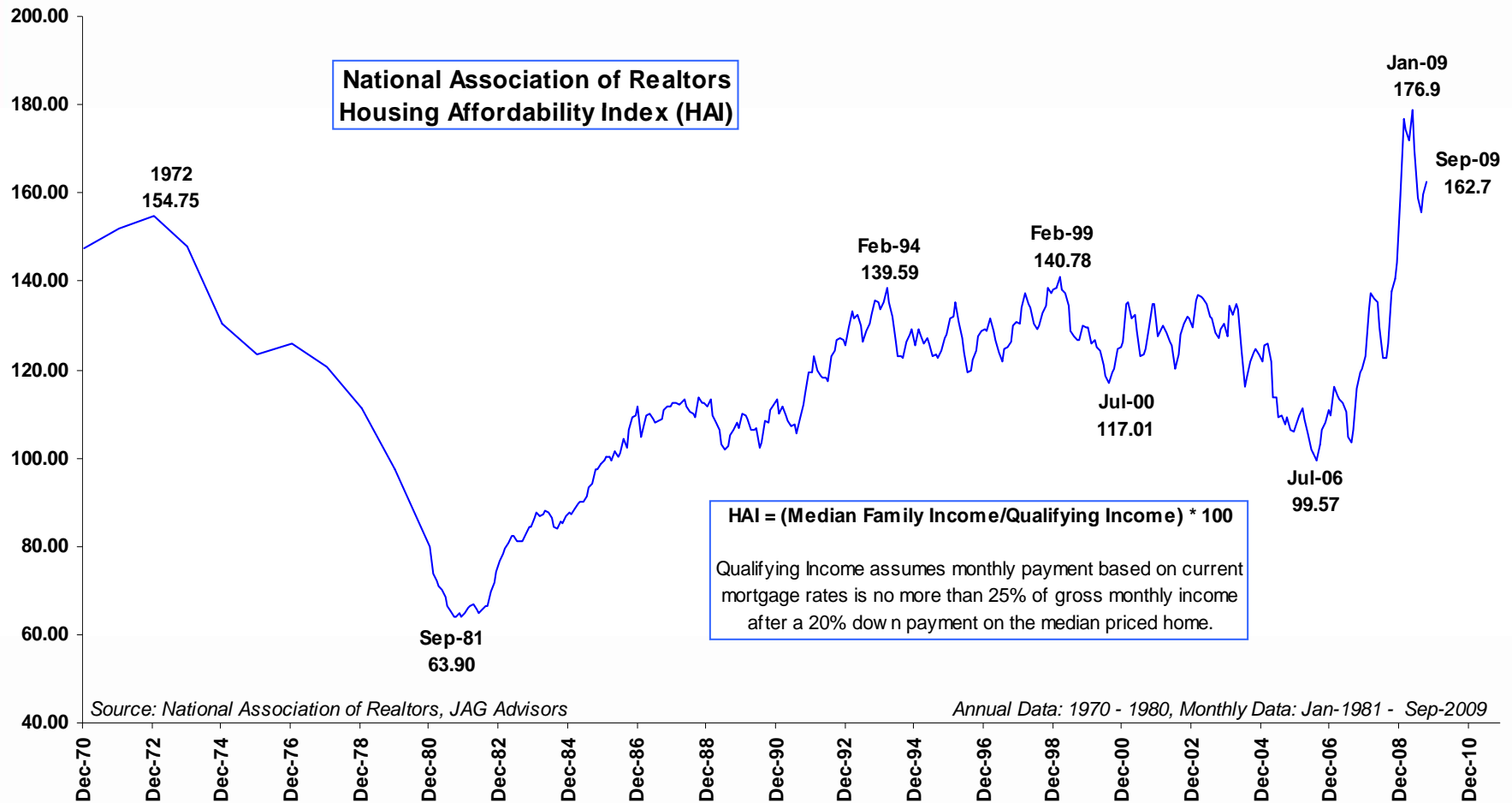
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# Potential Multi-Decade Bottom in Housing Starts



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# Seeds of A Recovery - Homes More Affordable Than Ever



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## (Thankfully) Mean Reversion Works Both Ways

- The last ten years of U.S. equity performance has been horrible
  - In both nominal and real terms, the trailing ten-year return of the S&P 500 for the period ending 9/30/09 were among the worst 10% of rolling ten-year returns ever
- However, market history gives strong justification to optimism
  - If history is a guide, the next three to five year outlook *should* be much better
- Bottom line: stocks are likely to post higher nominal and real returns over the coming years
  - Clients are hiding in low-return cash assets because of “sunk cost” bias and myopic loss aversion
  - Cash is likely to be unattractive as investors come off the sidelines
    - Especially if/when inflation ramps up!



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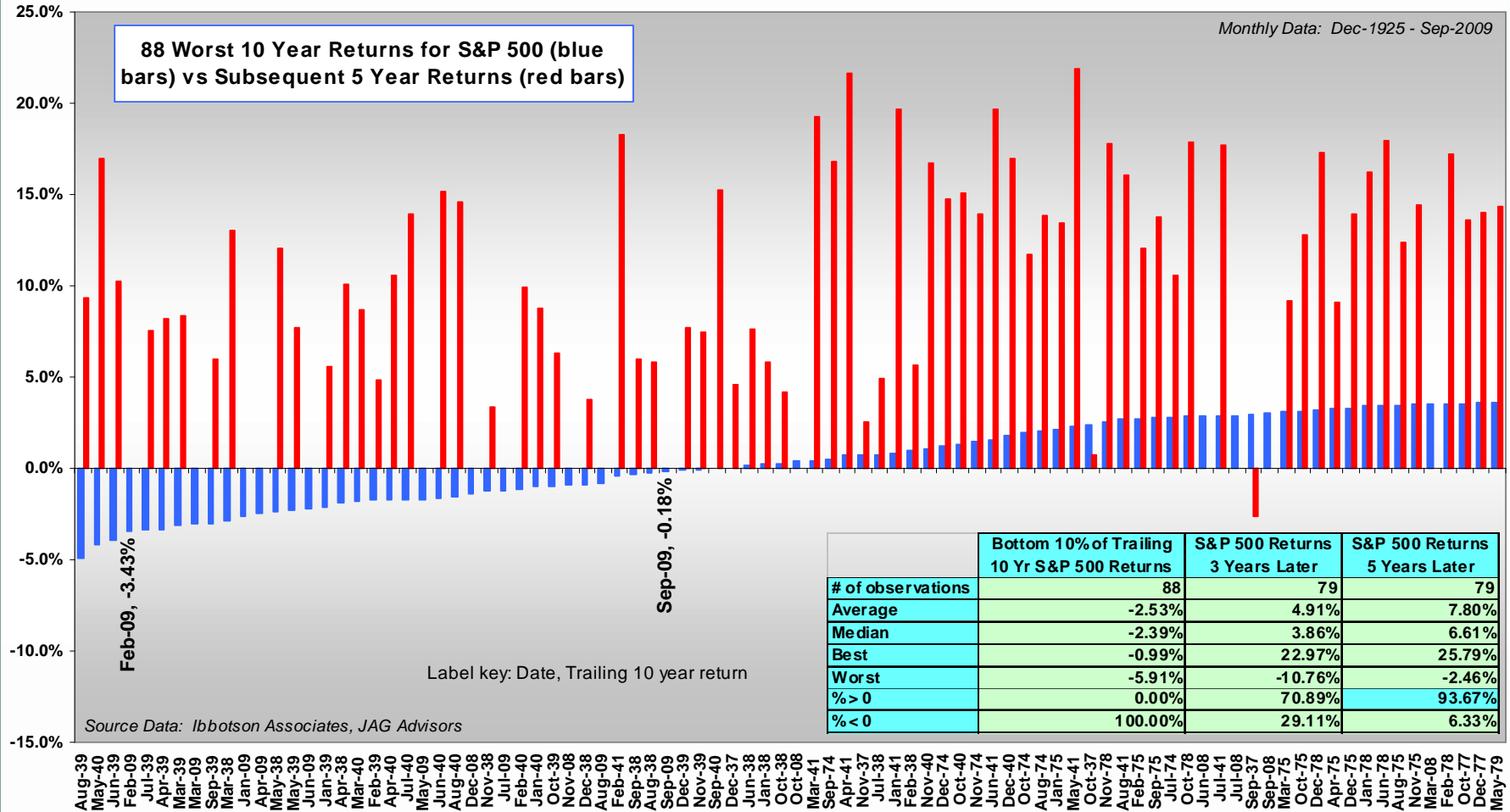
# Bull Market Gains Far Exceed Bear Market Losses

BegDate	EndDate	Bear Market Declines	Length of Bear (days)	Bull Market Gains	Length of Bull (days)	Time to Previous Peak (days)
5/29/1946	6/13/1949	-29.6%	1,111	266.3%	2,607	361
8/2/1956	10/22/1957	-21.5%	446	86.4%	1,512	337
12/12/1961	6/26/1962	-28.0%	196	79.8%	1,324	434
2/9/1966	10/7/1966	-22.2%	240	48.0%	784	209
11/29/1968	5/26/1970	-36.1%	543	73.5%	961	650
1/11/1973	10/3/1974	-48.2%	630	125.6%	2,248	2,114
11/28/1980	8/12/1982	-27.1%	622	228.8%	1,839	83
8/25/1987	12/4/1987	-33.5%	101	582.1%	4,494	600
3/24/2000	10/9/2002	-49.1%	929	101.5%	1,826	1,694
10/9/2007	3/9/2009	-56.8%	517	?	?	?
<b>Average</b>		<b>-35.2%</b>	<b>534</b>	<b>176.9%</b>	<b>1,955</b>	<b>720</b>



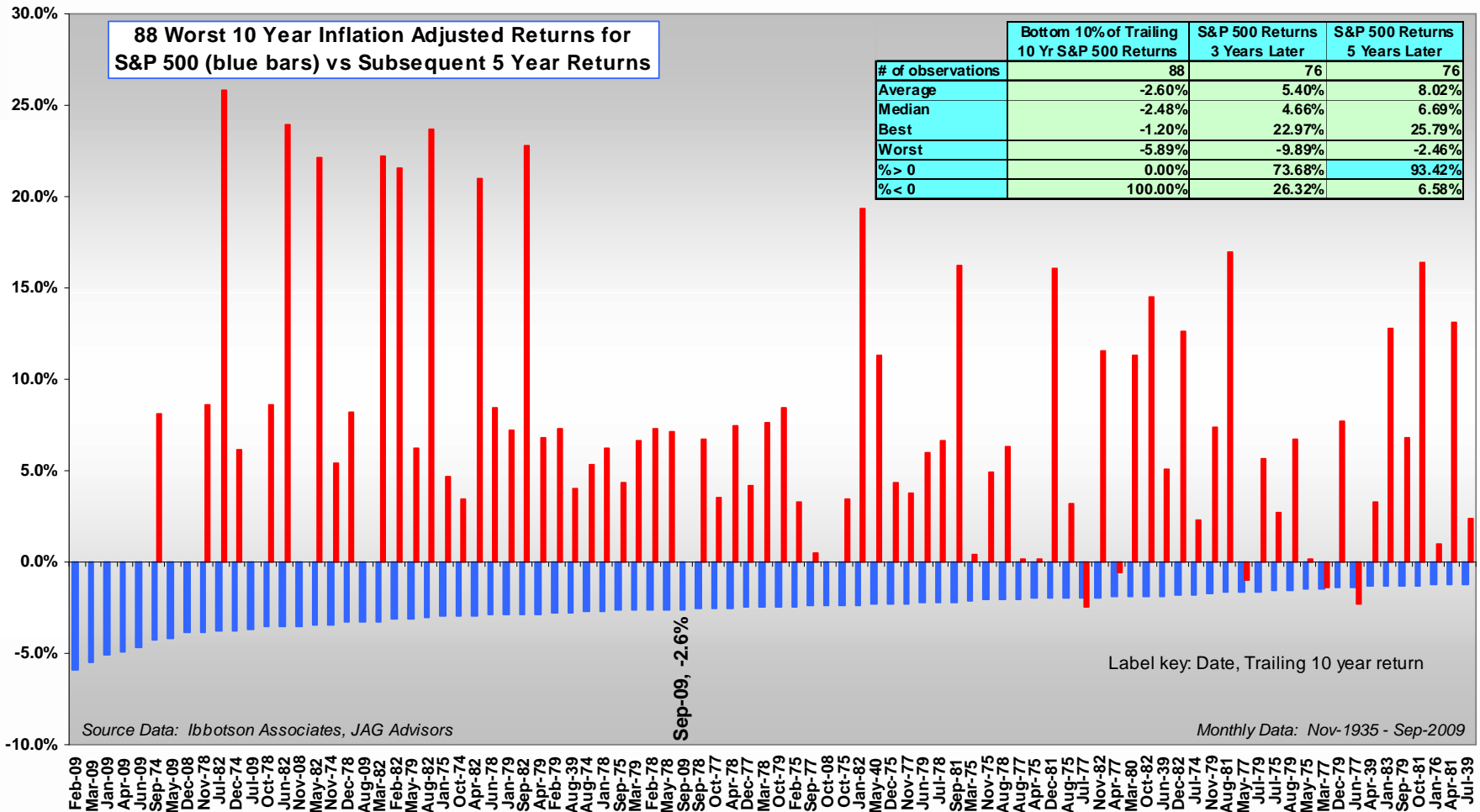
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# In Nominal Terms, Good Follows Bad 99% of the Time



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# Adjusting For Inflation, Good Follows Bad 94% of the Time

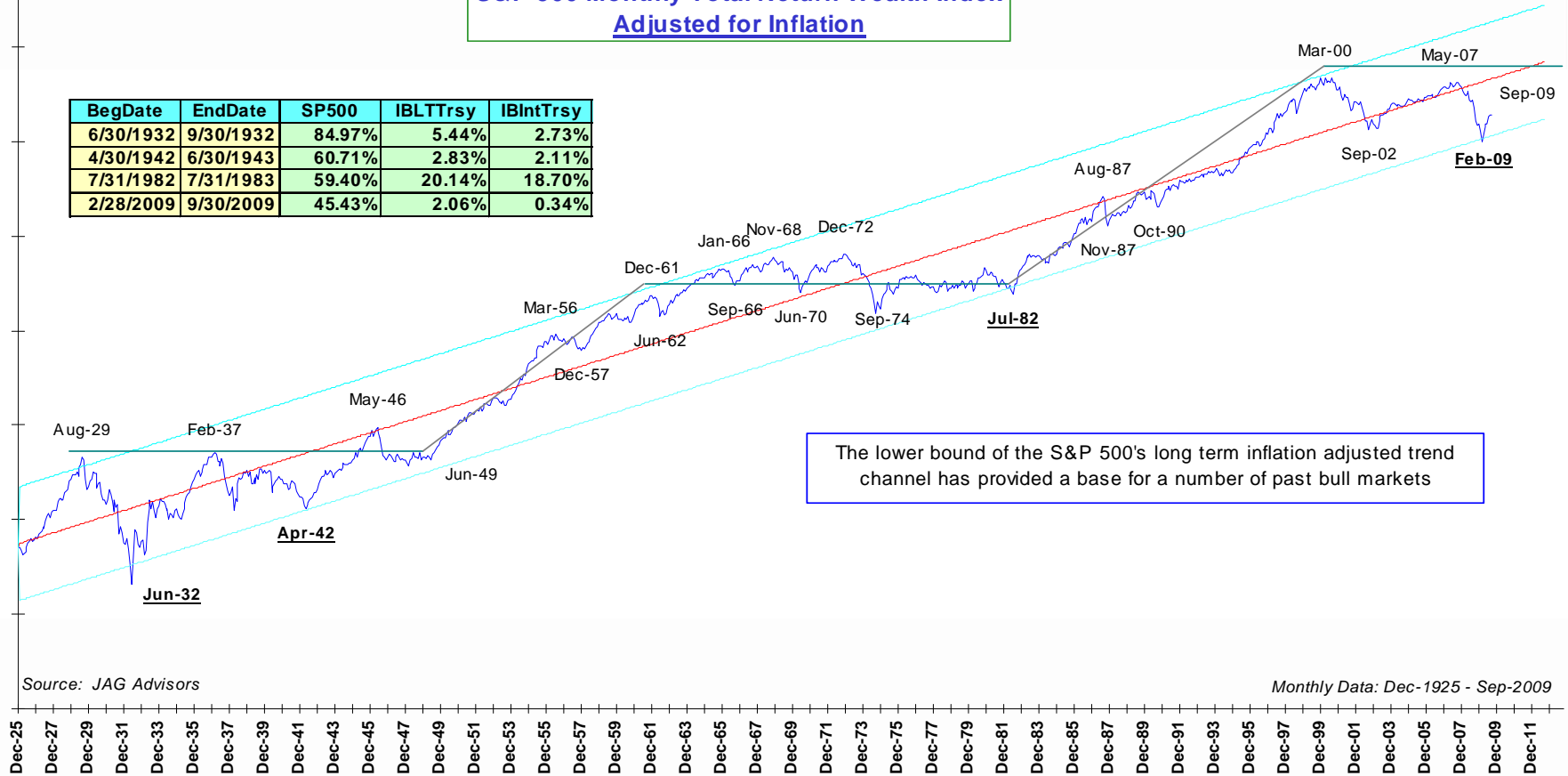


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# Lower Channel Provides Support

**S&P 500 Monthly Total Return Wealth Index  
Adjusted for Inflation**

BegDate	EndDate	SP500	IBLTTrsy	IBIntTrsy
6/30/1932	9/30/1932	84.97%	5.44%	2.73%
4/30/1942	6/30/1943	60.71%	2.83%	2.11%
7/31/1982	7/31/1983	59.40%	20.14%	18.70%
2/28/2009	9/30/2009	45.43%	2.06%	0.34%



Source: JAG Advisors

Monthly Data: Dec-1925 - Sep-2009



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# Equity Market Outlook

- 2008 was our generation's "Annus Horribilis"
  - Investors and Pro's need to be careful not to have learned the wrong lessons from '08
- Stocks are expensive on trailing EPS
  - But this is more because of the "E" collapsing
  - "P"'s are still well below peak levels
  - Forward PEG's (especially versus 2011 estimates) are not excessive
- Stocks offer compelling relative value
  - Inflation protection
  - Call option on faster-than-expected economic growth
- Big Cap U.S. Growth reasonably-priced
  - S&P 500 cheapest versus MSCI World index since 2003
  - For Euro-based managers, U.S. profits available at <14 Euros – which is cheapest ever
  - S&P 500 P/E of 20 looks compelling relative to MSCI World P/E of 27
  - Don't forget Earnings Yields (!) S&P FEY > 5%



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## Current Growth P/Es Below 5 Year Average

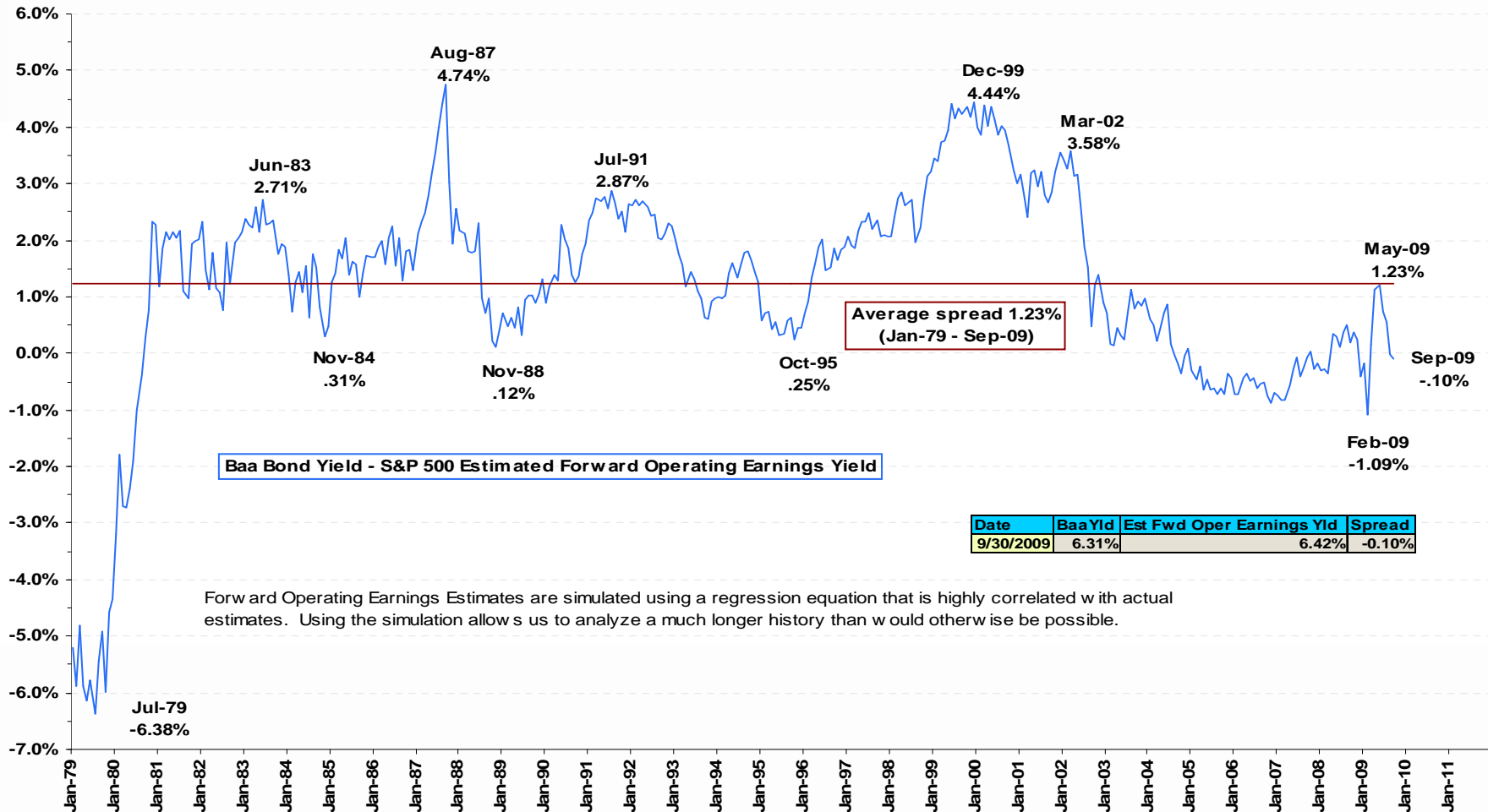
	Current P/E as % of 5-year avg. P/E		
9/30/2009	Value	Blend	Growth
Large	1.12	1.04	0.95
Mid	1.04	1.00	0.94
Small	0.96	0.96	0.93

*Source: Russell Investment Group, JAG Advisors*



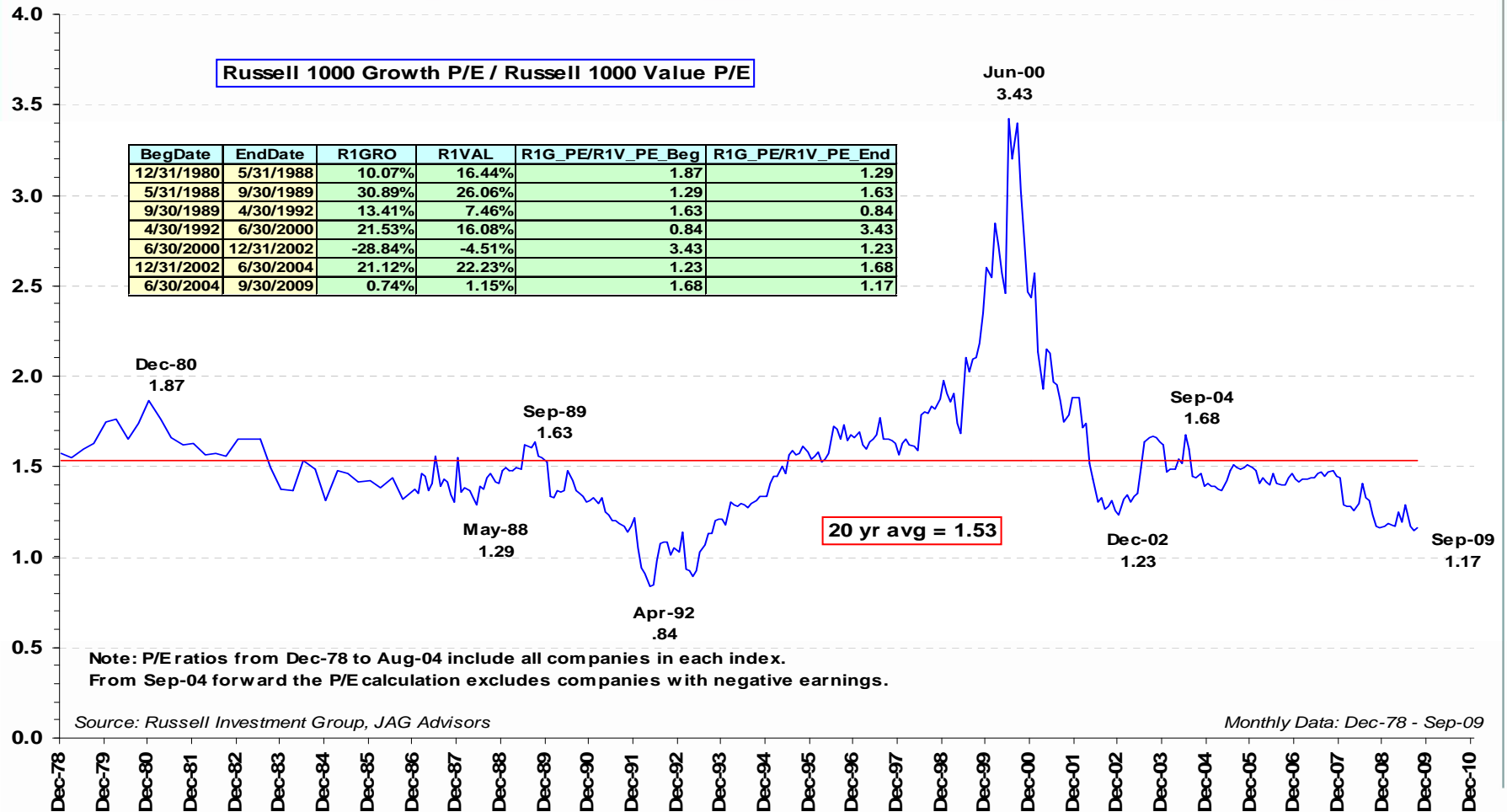
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# Forward Earnings Yield Attractive vs. Bond Yields



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# Growth P/Es Below Average vs. Value P/Es



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# JAG Large Cap Growth Crib Sheet

- **Overweight:** Technology, Consumer Discretionary, Financials
  - Technology: low/no debt, annuitized streams, nimble business models, potential secular growth surrounding Internet 2.0
    - AAPL, GOOG, EMC, INTC
  - Consumer Discretionary: sector has been posting strong relative performance since 7/2008, post-recession EPS bounce could be powerful, low valuations, less competition
    - TGT, URBN, AMZN, DSCA
  - Financials: Near-Armageddon experience setting stage for outperformance, yield curve is a tailwind (banks), I-Banks benefitting from wide fixed-income spreads and M&A rebound, competitive yields
    - GS, STD
- **Underweight:** Consumer Staples, Industrials
  - Industrials: need to see more evidence of top/bottom line growth, where are stimulus \$\$\$ (?), valuations only cheap/reasonable if EPS can ramp into 2010/2011
  - Consumer Staples: high single-digit Revenue/EPS multiples are not compelling as “early cycle” plays
- **Equal Weight:** Health Care, Materials
  - Health Care: positioned in devices, biotech, avoiding “big pharma” and health insurers
  - Materials: metals and mining should do well, but volatility keeps us from making too much of a bet here
- Revenue growth will be a key metric over coming several quarters
  - Top-line growers will be rewarded as the recovery continues (as long as margins behave)
  - Negative forward guidance will be penalized excessively
  - We are positioning portfolio accordingly!



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