



Turning Our Chairs Around to Watch the Recovery

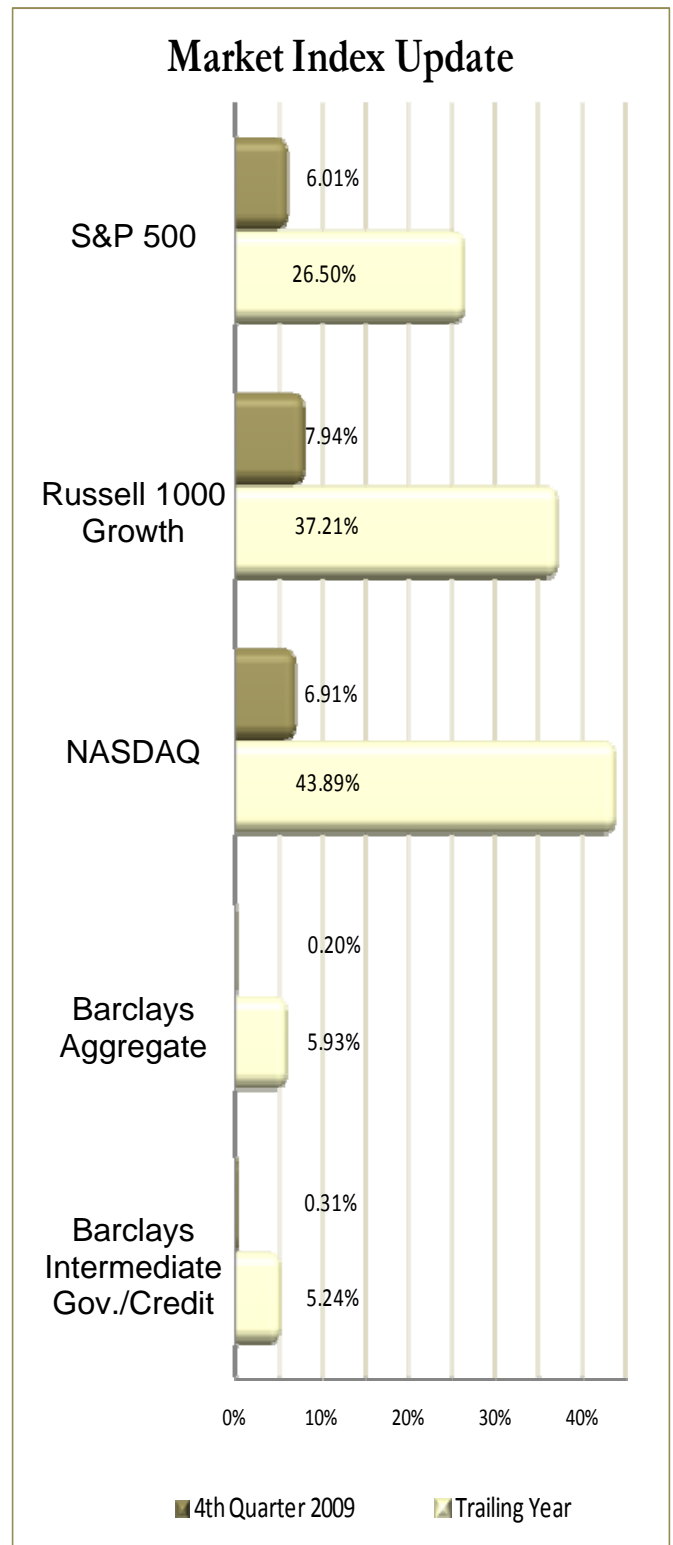
After weathering an historic crash in 2008 and early 2009, Mr. Market "turned his chair around" last March to look for positive signs of an impending economic recovery. Evidently he liked the view, as equity markets worldwide spent the last three quarters climbing the highest "wall of worry" in modern times. Fueled by a stimulating brew of investor relief, accommodative Fed policy, a weak dollar, and historically low valuations, the S&P 500 rallied over 65% from its early March nadir to close the year at 1115.

From the data we review, it is apparent that The Great Recession ended sometime during the 2nd or 3rd quarter of 2009. While we wait for the National Bureau of Economic Research (NBER) to officially confirm this fact, we note that a wide swath of economic and market indicators bottomed in mid-2009. The economy is indeed recovering, with the speed and magnitude of recovery into 2010 being a very open question. But for now, we expect to continue to position our portfolios to benefit from early/mid-cycle economic strength.

Throughout the past two years, our favorite statistic has been the ratio of BAA bond yields to 10-year Treasuries (**figure 1 on the reverse**). Looked at inversely, this ratio nicely captures the risk appetite of the financial markets. That is, *higher* ratios imply *lower* risk appetites, and vice-versa. The *trend* of this ratio is also important, in that a *rising* BAA/10-year ratio implies that investors are becoming more skittish, while a *declining* ratio indicates a growing appetite for risk in the marketplace.

During the summer of 2007, the BAA/10-year ratio began to tick up, as investors began to see storm clouds on the horizon. Thus began the greatest financial crisis since the 1930's. In fact, in December 2008, this ratio reached the highest level ever, surpassing the previous high point of June 1932. From our perch, it became apparent that the market outlook had become truly binary. Either we were on the brink of the Great Depression 2.0, or we were not. There was very little room between the extremes of disaster and redemption.

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At the time, looking out across the chasm, we made a bet on the market's ability to work towards a redemptive rally, due in no small part to the fact that the BAA/10-year ratio began to improve in late December 2008.

Our thesis was that firmness at the top of the capital stack (debt instruments) would lead to better prices for assets at the bottom of the capital stack (equities). And while financial sector credit spreads did not peak until February 2009, modest overall improvement in credit conditions between December 2008 and January 2009 made us confident that the tide was beginning to turn for the markets. Thankfully, we both anticipated (see our "Mud and Stars" presentations from February and April 2009) and benefited from the market recovery in our equity and fixed income strategies.

As of 12/31/09, the BAA/10-year ratio was 1.66, down by 59% from the December 2008 high of 3.90. While there remains room for improvement, credit markets are discounting a continuation of the nascent economic recovery, and we believe the BAA/10-year ratio is supportive of continued equity market gains into 2010.

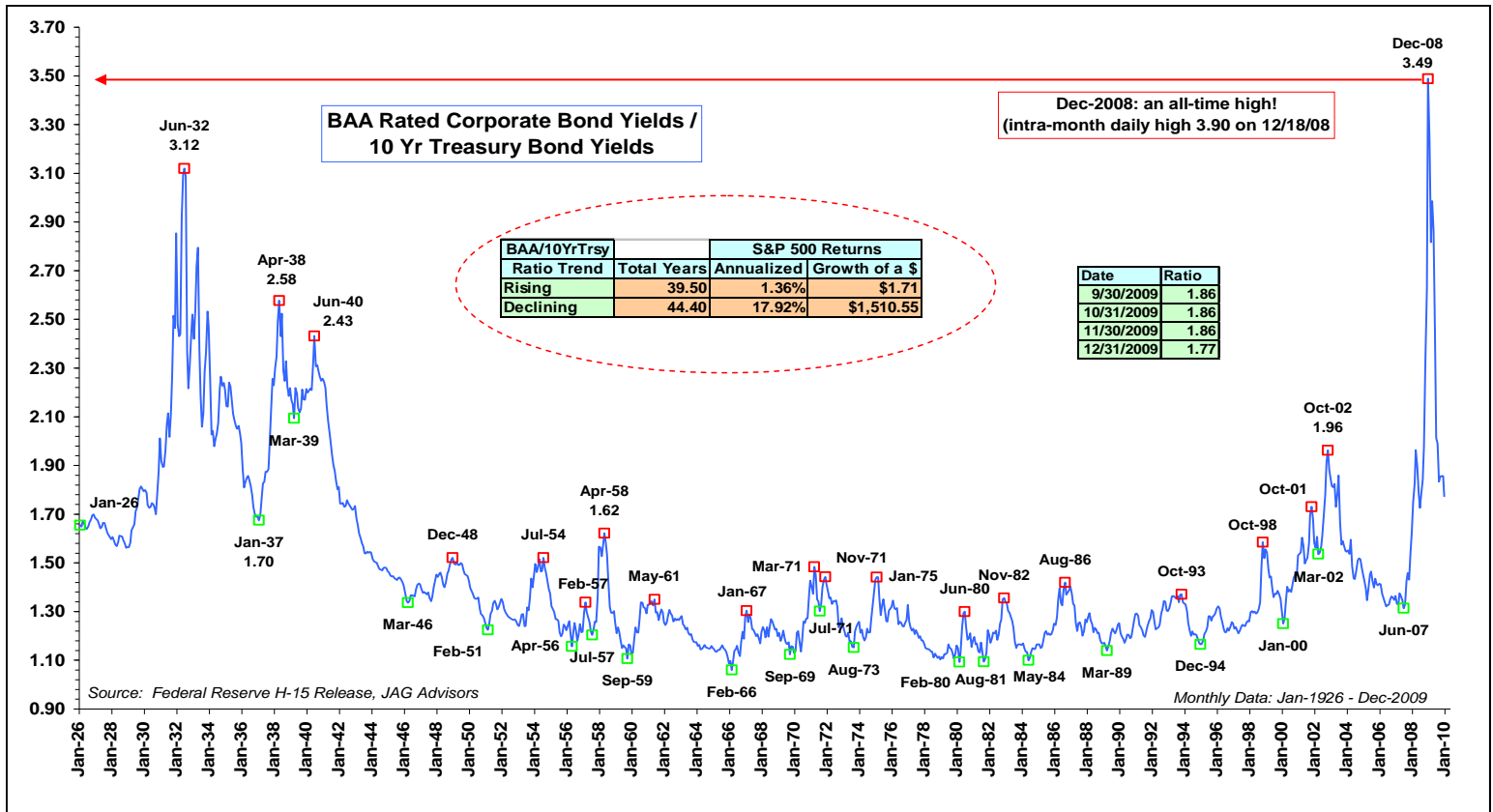


Figure 1

Outlook

For those questioning the staying power of the rally, it is worth noting that the S&P 500 remains 11% below the level it closed at on September 12, 2008 – the last trading day prior to the epochal collapse of Lehman Brothers. Given the fact that credit markets have recovered fully from their post-Lehman meltdown, we think it is likely that equities will follow suit in the coming months. Therefore, we expect that equity returns in 2010 will be solidly positive, albeit lower than the returns realized by equity investors in 2009. We are projecting the S&P 500 to return between 8% and 20% in 2010.

The relatively wide range in our return outlook is reflective of our uncertainty about the slope of the economic recovery, the overall interest rate and inflation backdrop, and the political milieu in the U.S. as Congress lurches towards the mid-term elections in November 2010. A mid-point return of 14% sounds just about right to us, which would recapture the post-Lehman losses and leave the S&P 500 at a level of approximately 1270 by year-end 2010. In order for our best-case scenario to be reached or surpassed, the economy would need to recover strongly (i.e. GDP 4.5%+), inflation would have to stay subdued (i.e. CPI < 3.5%), interest rate increases would have to be modest (i.e. 10-year Treasury yields < 5%), and the mid-term elections would have to move government closer to gridlock (i.e. GOP would have to pick up a lot of seats in Congress during the mid-term elections).

In contrast to 2009, we do not think that rising tides will lift all boats in 2010. If we are correct in this view, we believe that active managers will have a much better opportunity to add value in the New Year than they had in the heady second half of 2009. More specifically, we believe that sustainable *top-line* growth will become an increasingly significant factor in individual stock valuations.

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Companies which rely too much on expense cuts to drive earnings growth will be penalized, while those which show an ability to drive superior sales growth (either due to cyclical or secular trends) stand a good chance of being rewarded with multiple expansion and higher stock prices. Within our equity investment process, we have slightly adjusted our factor weights to add emphasis to sales growth results, and our team will carefully examine quarterly earnings reports to identify companies with outsize top-line growth potential.

Our optimistic outlook is apparently firmly outside of investor consensus. Domestic equity mutual funds experienced net outflows throughout 2009, and preliminary data indicates that the pace of equity fund outflows actually *increased* during the 4th quarter. Bond funds, on the other hand, have been huge beneficiaries of investor fear for much of the past year. According to Citigroup Global Markets, bond funds received over \$312 billion in net inflows through October 2009, which represented a greater than 500% year-over-year increase *and* the largest 10-month inflow ever. More evidence of investor caution was provided on December 17, 2009, when PIMCO's Total Return Fund became the largest mutual fund ever – with a staggering \$202.5 billion in assets. With all due respect to Total Return Fund manager Bill Gross, who ranks as one of the top 10 investment managers of all-time, we question whether his more-recent investors are more enamored with his fund's trailing performance (which is excellent) than its prospective return. We would also note that PIMCO, which has historically focused almost exclusively on bonds, recently decided to launch a variety of actively-managed equity funds. Could it be that even PIMCO sees a brighter future ahead for stocks? The old adage "Watch what they *do*, not what they *say*" comes to mind.

As relatively stable, income-producing assets, we think that bonds have a place in almost everyone's investment portfolio. However, we are hard-pressed to come up with a rational scenario in which low-yielding fixed income investments produce a higher total return than the S&P 500 over the next decade. The fact that a gigantic proportion of the investing public appears to disagree with us only serves to buttress our optimism as we enter the New Year.

All of us at JAG wish you and yours a happy, healthy, and prosperous 2010.

Norm Conley
CEO
January, 2010