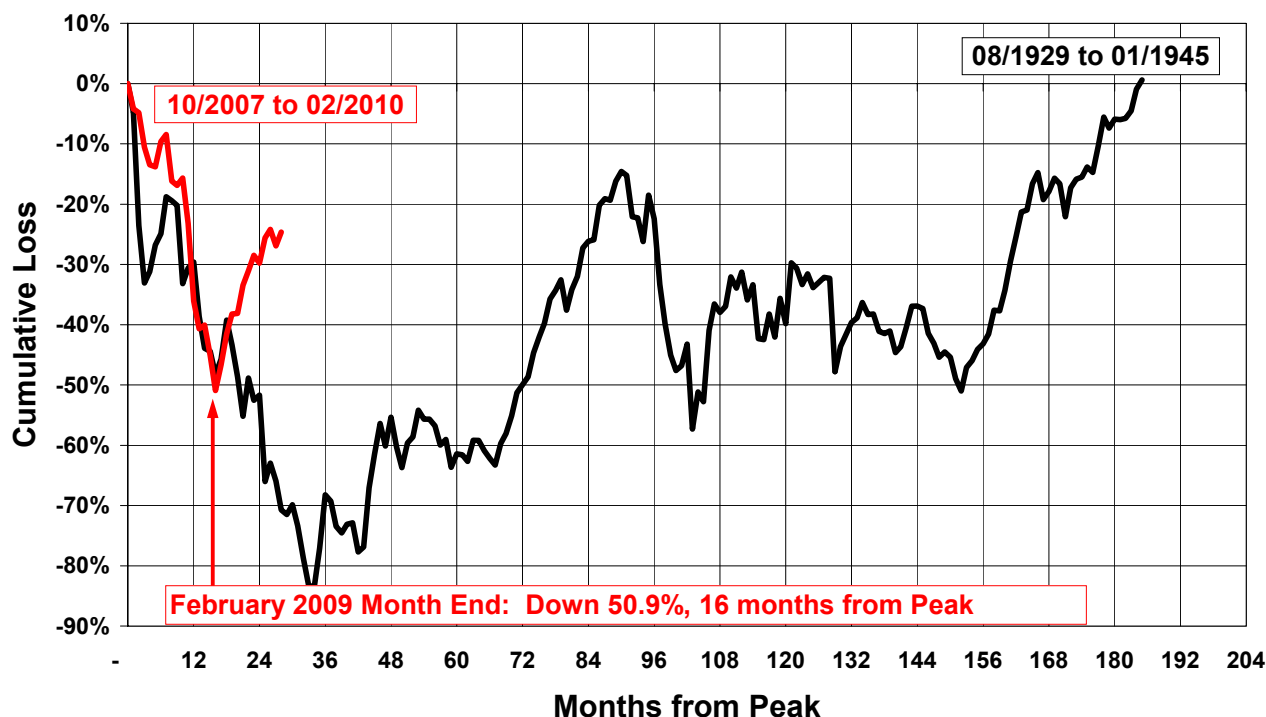


Beware the Consensus View

About this time last year, we published a piece titled, *The Anatomy of a "Great" Bear Market*. Sentiment was extremely bearish. The S&P 500 was down more than 50% from its peak and following the tracks laid down during the 1929-31 bear market. Here is the bear market comparison we showed you, updated through February 2010:

Current Bear Market vs 1929

Month-End Data through February 2010



In the first 16 months from the peak in 2007, the market fell by almost 51% versus a loss of just over 48% from the 1929 peak. Measured through the first 16 months, the current bear market was worse than the bear market that began in 1929. From Feb-2009 through Feb-2010, the market returned over 53%, putting the idea of a repeat of the 1929-31 experience far behind us.

Pause here for a moment and recall the frenzy. **The consensus view last February/March was that we were in the abyss of another Great Depression. In actuality, the market was making a bottom.**

Now roll the clock ahead to the end of the year. Ten months later, Bloomberg published the results of their Global Confidence Survey on

January 13th, 2010. The headline: **"Investors Turn Bullish on Stocks from U.S. to Japan on Economy"** – this, *after* the market has already gone up more than 50%. The S&P 500 peaked six days later and fell a little over 7%. **So much for the consensus view.**

What about the fundamentals? A year ago, using the 1929-32 bear market as an analog, we argued that **there was an extreme**

price/value discrepancy between the market and the economy – market performance was not justified by economic performance.

The equity market was performing worse than the Great Depression market, but the economy was performing much better (in a relative sense). Here is one of economic comparisons we showed you:

U.S. Economy 1st Year After Peak - Annual Averages			
Measure	1930	2008	Difference
Real GDP Growth	-8.6%	1.1%	9.7%
Nominal GDP Growth	-12.0%	3.3%	15.3%
Inflation Rate	-3.7%	2.2%	5.8%
Unemployment Rate	8.7%	5.8%	-2.9%

Source: Bureau of Economic Analysis, FDX Advisors
Data as of the February 27, 2009 Revision

We may have been on the edge of the abyss, but by key economic measures, we were not yet in it. Policymakers, intent on not repeating the mistakes of the Great Depression, were in the process of massive fiscal and monetary expansions. Now that we have another full year under our belt, we provide a table comparing 1931 versus 2009:

U.S. Economy 2nd Year After Peak - Annual Averages			
Measure	1931	2009	Difference
Real GDP Growth	-6.5%	-2.4%	4.1%
Nominal GDP Growth	-16.1%	-1.3%	14.9%
Inflation Rate	-10.3%	1.2%	11.5%
Unemployment Rate	15.9%	9.3%	-6.6%

Source: Bureau of Economic Analysis, FDX Advisors
Data as of the January 29, 2010 Revision

While 2009 deteriorated from 2008 as we knew it was doing at the time, it far surpassed the performance of 1931. The previous two tables are based on annual averages. Based on more recent data, the economy has started growing again and unemployment *may* have peaked at 10.1% last October. **We did not step into the economic abyss in 2009. We stepped away from it. Now, policymakers must navigate the withdrawal of the excess stimulus** – the extraordinarily large Fed balance sheet and fiscal deficit - in the face of a weak consumer and high debt levels.

Currently, the brand name, top-down opinion makers are tilted to a negative view – PIMCO’s Mohamed El Erian and Bill Gross; Morgan Stanley’s Stephen Roach; NYU’s Nouriel Roubini; Harvard’s Kenneth Rogoff – **while the bottom-up players like what they see with respect to company earnings.** Analysts expect 25% earnings growth for S&P 500 companies for the current fiscal year and estimates have been revised up in the last four weeks according to Bloomberg.

So, at present, “rational” people disagree and animal spirits are subdued. This is probably good for the market.

It is also a good time to revisit strategic investment plans with your clients. Take the opportunity ensure strategic risk exposures are appropriate while clearer heads can prevail.

Animal Spirits

“...one should reject the notion that stock prices reflect predictions, based on economic fundamentals, about future earnings. Why? The prices are much too variable. Even this fact, blatant as it is, has not convinced efficient-markets advocates that their theory is wrong.”

This is an excerpt from the book, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, by George Akerlof and Robert Shiller, published in January 2009. It is worth a read for anyone interested in alternative

thinking on the economy and markets other than that offered by the efficient-marketeers.

Early in the book they give a “nod” to rational-person based economic theory...

“So even at its worst, this theory deserves high marks – at least by the criterion of a schoolboy we once overheard at a restaurant. He was complaining about the C he received on the spelling test – despite the fact that 70% of his answers were correct.”

...then go on to point out that:

"...it fails to take into account the extent to which people are irrational or misguided. It ignores the animal spirits."

It is these *animal spirits*, collectively moving from one extreme to another, that drive the evolving *consensus view* and the market roller coaster we have been riding. Extreme price/value discrepancies near the top in 2000 or the bottom in 2009 are just more evidence that market prices are much more volatile than the fundamentals they are trying to predict.

So, markets can be irrational and move far from the fundamentals.

For investors that take too much risk, the markets can stay irrational for longer than they can take the pain or stay solvent.

For disciplined investors that keep their risk exposures within their capacity to take risk, the extreme price/value discrepancies created by an irrational market offer opportunities.

Strategic Risk Manager

One of the most important services wealth advisors and investment consultants can provide their clients is that of Strategic Risk Manager. **This is about helping clients get the big decisions right over time:**

1. Do they have a strategic asset allocation target that is appropriate to their long-term goals?
2. Do they have a strategic asset allocation target that is appropriate to their risk tolerance?
3. How will their asset allocation evolve as compensation for taking risk evolves with animal spirits?

Industry practices around #1 and #2 are well-established in both the institutional consulting space and the wealth management space. Both use a combination of consulting and planning. The planning process is primarily analytical in nature. It involves asset class selection¹, efficient frontier analysis and forecasting financial results, using long-term capital market assumptions, to identify portfolios that will help clients manage liability risks and achieve their goals over time. The consulting process is primarily behavioral in nature. It involves helping clients clarify their personal preferences and risk tolerance through the client questionnaire and by using the planning process to help the client explore the risk-reward trade-off. These practices help give the client confidence their investment plan is on solid footing, and that their chosen strategic asset allocation target is appropriate to both their long-term goals and their risk-tolerance.

Where industry practice can be improved is in managing the strategic asset allocation target over time, particularly as the compensation for taking risk evolves. The typical process for managing the allocation target over time is some form of an annual review or update to the investment plan. **The annual review is an important step but falls short when the client risk tolerance is not explicitly quantified and captured in the process:**

1. If the capital market assumptions are based on very long-term averages, then the asset allocation target does not adjust according to the client risk tolerance as conditions change. The only time the allocation target is consistent with the client risk tolerance is when current conditions are close to the long-term average.

This approach identifies what the strategic asset allocation target should be on-average and converts it into a constant.

¹ See our July 2009 Advisor Note for more on asset class selection and macro economic drivers.

- If capital market assumptions are adjusted to reflect current conditions then, to achieve the required return of the investment plan, the asset allocation target moves in a direction that is opposite of that implied by the client risk tolerance.

This is counterintuitive. Consider the following alternatives with a 6% required return:

- 6% expected return for bonds and 12% for stocks – a 100% bond portfolio can achieve the required return, but equities are much more attractive.
- 3% expected return for bonds and 6% for stocks – a 100% stock portfolio is necessary to achieve the required return, but stocks are not very attractive.

The two flaws above are reasons why many people held too much in stocks before the 2008-09 debacle and then sold near the lows. They had too much risk exposure relative to their tolerance for risk. They could neither take the emotional pain, nor any further hit to their financial resources.

The FDxA Strategic Tilts framework² explicitly quantifies and captures client risk tolerance in the asset allocation process. This means quantifying client risk tolerance based on the client's normal asset allocation target under normal economic conditions, and also applying it under current economic conditions to set the current asset allocation target. The difference between the current target and the normal target defines the strategic tilt. Using this method over a full valuation cycle, the client will tend toward holding the strategic normal allocation on-average while holding a less risky portfolio during periods when expected compensation for risk is low and vice versa. **The framework better maintains the connection between the client's risk tolerance and actual risk exposure as expected compensation for risk changes, which serves to improve the client experience.**

Below is an update of a table we showed you in November 2009. For an investor with a moderate risk tolerance and a normal 50/40/10 (stocks/bonds/cash) portfolio, here is how the equity exposure has varied versus the normal long-term target as the crisis accelerated in October of 2008.

Month	Normal Equity Weight %	Recommended Equity Weight%	Strategic Equity Tilt %	S&P 500 Return%	Equity Tilt Gain/Loss%
Oct-08	50.0	35.0	(15.0)	(16.8)	2.5
Nov-08	50.0	35.0	(15.0)	(7.2)	1.1
Dec-08	50.0	35.0	(15.0)	1.1	(0.2)
Jan-09	50.0	36.0	(14.0)	(8.4)	1.2
Feb-09	50.0	36.0	(14.0)	(10.6)	1.5
Mar-09	50.0	48.0	(2.0)	8.7	(0.2)
Apr-09	50.0	36.0	(14.0)	9.6	(1.3)
May-09	50.0	38.0	(12.0)	5.6	(0.7)
Jun-09	50.0	65.0	15.0	0.2	0.0
Jul-09	50.0	65.0	15.0	7.6	1.1
Aug-09	50.0	65.0	15.0	3.6	0.5
Sep-09	50.0	45.0	(5.0)	3.7	(0.2)
Oct-09	50.0	41.0	(9.0)	(1.9)	0.2
Nov-09	50.0	35.0	(15.0)	6.0	(0.9)
Dec-09	50.0	35.0	(15.0)	1.9	(0.3)
Jan-10	50.0	35.0	(15.0)	(3.6)	0.5
Feb-10	50.0	65.0	15.0	3.1	0.5
Mar-10	50.0	65.0	15.0		

Maximum over/underweight of 15%

The model reduced equity exposure when risk levels were very high in the 4th quarter of 2008 and most of the 1st half of 2009, before taking advantage of improved valuations in the June through August 09 period. It then began reducing equity exposure as valuations rose and risk levels remained somewhat elevated. With the correction in January of this year, improvement in the economy and moderating expected risk, the model re-established an overweight equity position.

For those interested in learning more about our strategic tilt model and asset allocation services, please contact your relationship manager or reach us directly at advisor.notes@foliodx.com.

² See our November 2009 Advisor Note for further information on our Strategic Tilts framework.

Important Information and Disclosures

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. The information contained herein is believed to be accurate but has not been independently verified.

Asset allocation analysis may assist you in determining if you have the right mix of investments for a given set of objectives and risk tolerance. Asset allocation does not ensure a profit or protect against losses in a declining market.

Diversification may help to reduce the effects of investment risks when gains in one investment class help offset losses in another. There is no certainty that any investment or strategy will be profitable or successful in achieving your specific investment objectives.

This report provides hypothetical information using historical data and rates of return. Depicted rates of return are not representative of the actual rate of return that you will experience with any particular investment product.

The performance of an unmanaged index is not indicative of the performance of any particular investment. It is not possible to invest directly in any index.

Past performance is no guarantee of future results. The information shown should not be considered as a prediction of any investment results. Principal values of your investments will fluctuate and when redeemed, may be worth more or less than your original investment.

Costs associated with an investment are not reflected in the illustrations [e.g., mutual fund sales charges, management fees, administrative fees, taxes, other maintenance fees or mortality fees]. If included, these costs would lower returns. Note that costs differ depending on the investment. Assuming two investments have identical returns, the investment with lower costs would provide a higher overall projected value.

Sources of information for this report include The Wall Street Journal, Bloomberg, Standard & Poor's, MPI Stylus, The CFA Institute, George Akerlof, Robert Shiller, The Bureau of Economic Analysis, The Federal Reserve, U.S. Census Bureau, U.S. Department of Labor and FDx Advisors.