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September 2010 Market Letter

Capital Markets Summary

After eight months of 2010 our economy has reached a crossroads. We are faced with deciphering whether the economy has successfully transitioned through a recovery phase and will continue on a path to normalized growth, or has it simply bounced off a historic down turn only to revisit recent lows after our initial stimulus has subsided.

We feel domestic growth is sustainable yet at a slow pace. Considering the dual impediments of unemployment and housing, domestic growth may not return to 4% in the near future. However, they are not imposing enough for the U.S. to stop growing and slip back into another recession.

(By the way, forget about a "double-dip". If we were still in the midst of a recession that term could be appropriate, but since the recession was determined to have ended in the 3rd quarter of 2009, if things were to turn weak once again, we actually would have *another* recession and not a double dip – technically speaking)

Data releases in August were promising as revised GDP growth came in at 1.6%, above the consensus estimate of 1.3%. This data also indicated a nice pick-up in consumer spending and consumer confidence, which hit a high in July and continued to rise in August. The strong trend in corporate profits has continued through the month, and cash on corporate balance sheets has remained high. That position should further drive mergers and acquisitions, lead to dividend increases, share buybacks and business reinvestment, which will support the economic recovery.

Absent any shocking global political scenarios or significant economic disappointments, we feel equities will continue to make gains through the end of the year. As of the end of August, equity markets had sold off from their high point in July and fell into negative territory for the year. The S&P 500 index declined 4.5% for the month, while the Dow Jones Industrial Average and the tech-heavy Nasdaq posted losses of 4.1% and 6.2% respectively. Eight of the ten S&P 500 sectors provided negative returns for the month, with the biggest losers being financials, industrials, and information technology. The defensive sectors of telecom and utilities were the only positive performers.

Across market caps, large and mid-cap stocks performed in tandem at -4.51% and -4.94%, while small caps declined by 7.46% for the month. International equity markets were also negative but fared a bit better than the U.S. market. The MSCI Developed Markets index was down almost 4%, but Emerging Markets fell less, declining only 2.2%. Below is a table with the year to date and month figures.

Fig 1.1

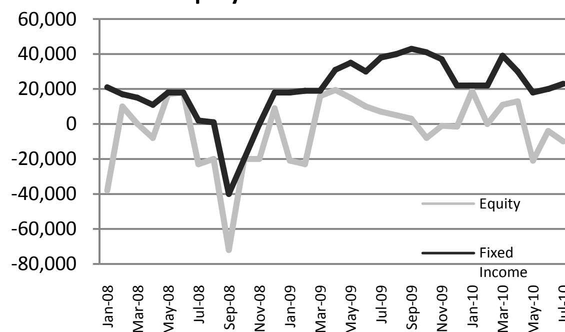
Returns through August 2010	1 month	YTD
S&P 500 (Large Cap)	-4.51	-4.62
S&P 400 (Mid Cap)	-4.94	-0.24
S&P 600 (Small Cap)	-7.46	-2.46
MSCI EAFE	-3.1	-7.95
MSCI EM (Emerging Markets)	-1.94	-0.33

Source: Standard and Poors and MSCI

In terms of Mutual fund flows, which can be a great indicator of retail investor sentiment, recent behavior has continued. As of the end of August money is still pouring into bond funds in lieu of stock funds. We see this pattern as supportive to fixed income investors seeking total return, but problematic to long-term investors in these securities. At some point investors will realize that stocks are cheap relative to bonds and a mass exodus could ensue, resulting in a significant decline in value of bond funds. A table of mutual fund flows since 2008 is provided below.

Fig 1.2

Fixed Income vs. Equity Fund Flows



Major mutual funds – Major disappointments

In an effort to measure which sectors institutions are buying in the equity investing world, we can analyze the largest mutual funds in the U.S. and compare their top holdings. Fund managers will allocate money to sectors and stocks that they feel will outperform. Mostly, these managers are not looking to hit home runs on these bets, but this data should tell us where the fund managers believe the best value lies.

In figure 2.1 we see an emphasis on Information Technology companies, as the largest mutual funds invest the greatest portion of assets in that sector at 21%. Ironically, we notice the IT sector is the worst performer YTD, losing 10% through the end of August. Financials, which have also performed quite poorly this year, are second with a weighting of 17%, followed by Health Care garnering 13%. Unfortunately, as

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the table indicates, these fund managers are heavily invested in the worst performing sectors this year.

Fig 2.1

Top 30 Largest Funds Sector Weightings	% allocation	YTD return
Information Technology	23%	-10.05%
Financials	17%	-4.66%
Health Care	17%	-8.11%
Energy	17%	-9.88%
Consumer Staples	13%	1.41%
Consumer Discretionary	7%	1.94%
Telecommunications Services	3%	1.33%
Industrials	< 2%	-0.78%
Materials	< 2%	-1.07%
Utilities	< 2%	1.93%

Source: Blackrock and CIRA div Citi GM Inc.

But why? These should be the best minds on Wall Street, managing hundreds of billions of institutional and retail investor dollars. Why is it they are so off the mark with their allocations?

The answer very likely lies in the notion that these managers – and their parent companies – do not want to stray too far from their benchmark. In most cases the benchmark for these large funds is the S&P 500 Index.

There is an understanding, perhaps an assumption, that these large fund managers are unwilling to implement alpha (outperformance over a benchmark) generating strategies because they do not want to drift too far from the one thing they are measured against time and again – their benchmark. Thus, managers construct portfolio's that are quite similar to their benchmarks but with less holdings in their portfolio. For example, if the S&P 500 index benchmark contains 500 companies (approximately), a comparable actively managed mutual fund may have only 100 holdings. However, the complexion of the sector allocation for that fund may be almost identical. If there is 20% exposure to the Health Care sector in the S&P 500 index, the manager will predictably have the same allocation. Rather than holding 100 or so Health Care companies comparable to the index, the fund may have only 20. So the manager has narrowed his focus to 20 selections from a possible 100, but he has not truly attempted to create alpha due to his lack of a differentiating sector bet.

With that said, let us turn back to our analysis of the largest equity funds, and see if they differ from their benchmark's sector allocation. The chart below is for both the S&P 500, and the largest 30 actively managed mutual funds.

Fig 2.2

S&P 500	Sectors	Mutual Funds
19%	Information Technology	23%
17%	Financials	17%
12%	Health Care	17%
12%	Energy	17%
12%	Consumer Staples	13%
10%	Consumer Discretionary	7%
3%	Telecommunications	3%
10%	Industrials	< 2%
< 3%	Materials	< 2%
< 3%	Utilities	< 2%

Source: Standard and Poors and CIRA div Citi GM Inc.

We see a very similar allocation between the index and the actively managed funds. Time and again, managers of mutual funds demonstrate an inability to take the requisite steps to distinguish themselves against the benchmarks.

Our conclusion, investors who seek true active management that can deliver alpha must hire an investment manager who is perceptive, uses a pure unbiased platform, and has the freedom to be both prudent and creative. In most cases the mutual fund industry is not the place to find this set of deliverables, and unfortunately it has taken a while for investors to realize it.

Coming up….

Next month we will take a look at the Yale Endowment, and illuminate its distinct investment methodology and performance.

Past performance is no guarantee of future results. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly. Investing in sectors may involve a greater degree of risk than investments with broader diversification. International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks.

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