the tortoise and the hare

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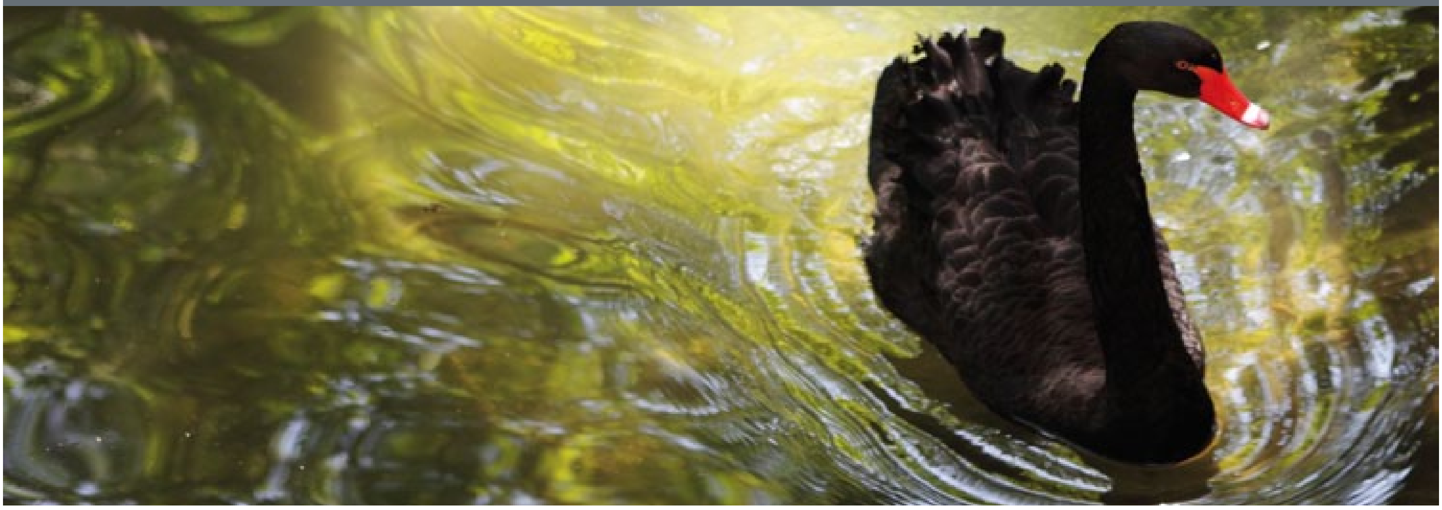

Fat Tails From Black Swans

As we know, in statistics, certain data follows a normal distribution (sometimes referred to as a bell curve), and that most observations occur near the mean/average and very few occur far away from the mean/average in the 'tails'.

The standard deviation tells us what percent of observations occur near the mean and the larger the standard deviation, the more frequent the observations occur away from the mean. In a normal distribution, 95% of the observations happen within 2 standard deviations (SD) of the mean and the probability of observations occurring outside of this range is very low. Certain data follows a normal distribution and others don't. For example, height follows a normal distribution and there are very few observations far away from the mean in the 'tails'. Financial markets prices do not follow a normal distribution and have many observations in both the far right and far left ends, thus exhibiting fat tails'. For example, if stock returns followed a normal distribution, then the probability of us experiencing market crashes (an event greater than 2 SD away from the mean) would be very low and would only occur once or twice in our lifetime (or once every 44 years). In reality, we experience stock and bond market crashes (and bubbles) far more frequently and have recently experienced 6 and 7 SD events which would only happen once every 3 billion years if market returns followed a normal distribution.

Benoît Mandelbrot wrote significant research on this topic and suggested that price changes in financial markets did not follow a normal distribution but rather a Lévy stable distribution making the problem of modeling risk much more difficult. In 1964, Eugene Fama[1] at the University of Chicago, under the supervision of Mandelbrot, wrote about fat tails in his PhD thesis and about how the movement of stock prices was unpredictable and followed a random walk. He went on to discuss how it was next to impossible to model fat tail risk and many models that are used today, such as Value-at-Risk, simply don't work in extreme circumstances. As Nassim Taleb has been telling us for years, it's impossible to predict the ramifications of Black Swans. Black Swan events such as September 11, countries like Russia (who never defaulted) defaulting on their debt, the first collapse of a major global investment bank (Lehman Brothers), etc. happen regularly and create 6 and 7 SD events. Looking at the past and trying to accurately model the future is next to impossible as no one can predict Black Swan events.

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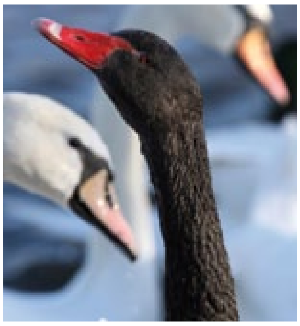
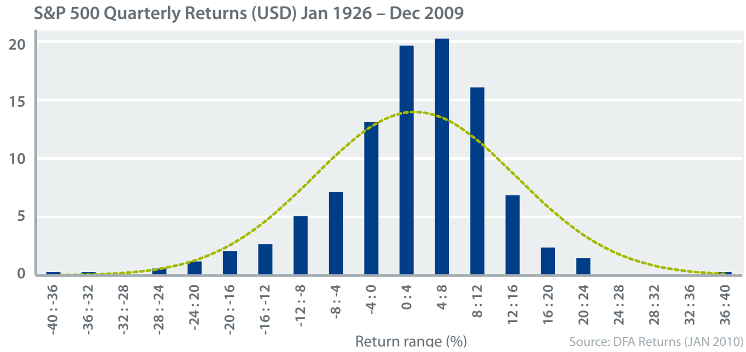
[1] Eugene Fama is the director of research at Dimensional Fund Advisors (DFA).





2008 and 2009 were good examples of years when fat tails occurred in the prices and volatility of many financial assets.

The best solution for such a problem is to diversify your investments amongst asset classes that provide some kind of value to your portfolio (return, low correlation, low risk, etc.) and then regularly rebalance your portfolio. 2008 and 2009 were good examples of years when fat tails occurred in the prices and volatility of many financial assets. After Lehman Brothers collapsed, the correlation of many asset classes spiked and the price of most risk assets fell significantly, quickly and in tandem until the first week of March 2009. At that point the price of many risk assets reversed and rose significantly and quickly in tandem until the summer when correlation amongst asset classes started to fall again. As an investor, a diversified portfolio provided you huge diversification benefits as treasuries and other government bonds appreciated while most risk assets fell. If you continued to invest in a diversified portfolio and rebalanced back to your strategic allocation in February, March or April, you were in effect selling government bonds near multi-year highs and buying risk assets near their multi-year lows. This is what we did for our discretionary accounts[2].

After a substantial rise in risk asset prices off their March lows, we have recently been rebalancing portfolios back to their strategic allocation again to ensure a consistent mix between high risk and low risk assets in line with each client's risk profile.

Summing Up The Year

Last year we saw an ongoing recovery in small, value, emerging, duration and credit premiums. International markets recovered more quickly than that of the United States and risk in equities and corporate fixed income decreased across markets. The VIX index (a measure of risk in equities) fell substantially from over 40 at the end of 2008 to under 20 at the end of 2009 as risk aversion abated. During the height of the financial crisis, the VIX index peaked at over 80. Risk aversion has also widely decreased except when it comes to many developed government bonds that have excess amount of debt and are now demanding higher yields to compensate for the risk. Also, as ever, diversification remains important as does a rebalancing strategy.

Concerns We Highlighted Last Year

Over the year we also highlighted our concerns about the risks in European government bonds of the PIIGS (Portugal, Ireland, Italy, Greece and Spain) and some Eastern European countries, the US economy in general and potential weakness of the USD and the extremely low yields in US Treasury Bonds. Some of these themes started to play out in 2009 and we think some will continue into 2010.

Piigs, The Euro & Euro Government Bonds

Fitch downgraded the Greek government's credit rating in December for the second time this year to BBB+ with a negative outlook. A few days later, Greece's prime minister spoke at an EU summit and admitted that his country's public sector was rife with corruption. On the same day, S&P downgraded its outlook for both Spain and Portugal. Prior to the fourth quarter, Greece, Spain, Ireland and Portugal already experienced credit downgrades and the UK suffered from a negative long-term credit outlook. This comes as the Bank of England pumped another £25bn into the economy in the fourth quarter up to a total of £200bn last year.

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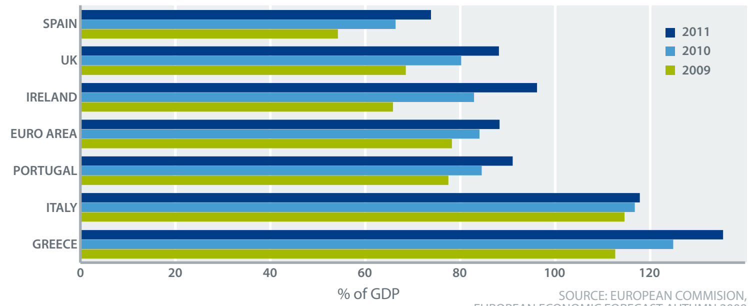
[2] In our Q1 Investment Quarterly, we wrote: 'Massive outflows from mutual funds are usually a contrarian positive indicator for future equity returns as evidenced by multiple academic studies. Many other indicators such as the Short Interest Share or Margin Debt as a percentage of Market Cap are also bullish indicators at this time. Although we do not know the current or future direction of equities, most major equity markets are now yielding substantially more than their country's government bonds. The last time we saw this in the US and UK was over 50 years ago and it also has not happened for decades in the rest of Europe. We expect the real economy to struggle in 2009 and we must ask ourselves whether this is already priced into the equity markets and if so, can you as an investor withstand the volatility that is almost certain to continue in 2009?'

At the beginning of the year we highlighted this concern and felt that long-term US Treasury yields would ultimately move higher in the US.

European Government Debt



SOURCE: EUROPEAN COMMISION, EUROPEAN ECONOMIC FORECAST AUTUMN 2009

In our previous Investment Quarterlies we have repeatedly warned about the excessive government debt burdens within Europe, the UK and the US and about the significant risk that yields would ultimately rise to reflect the greater risk associated with a government default. We saw government debt auction failures on multiple occasions and very recently debt auctions by the US government have been very weak, pushing yields up further. We have been experiencing rising yields on many government bonds from these countries all year and we believe yields can continue to rise further. We have been underweighting government debt in all of these countries which has paid off handsomely as many of these bonds lost value last year. This is in stark contrast to the rising value of government bonds in many less heavily indebted countries, an area we have been allocating to for some time.

USD & US Economy Weakness

The US Treasury Department extended the TARP (Troubled Asset Relief Program), which was due to expire in late 2009, to October 2010, as more than $118 billion of rescue money has been repaid by the banks. In 2009 US regulators closed 136 US Banks that failed and the number of FDIC-insured 'problem' institutions (552) leapt last year and reached a 16 year high. A year earlier there were only approximately 175 'problem' institutions and less than 100 a year before that. Last quarter, total loan balances by banks also contracted by 3%, the fastest decline in over 25 years. US unemployment surged to 10.2%. Since the recession began, more than 7.3 million people have lost their jobs in the US.

The fourth quarter, however, saw a large reversal for both US inflation and US unemployment. Inflation picked up and increased by about 2.7% year on year. 30-year mortgage rates in the US fell to a 30 year low of 4.71% in early December but have since risen in line with the long-term Treasury. November's unemployment numbers also finally bucked the trend and fell for the first time in more than a year. Retail sales rose for the second month in a row in November raising hopes that a consumer recovery is on the way.

All in all, the US economy appears to have stopped deteriorating and now the question is whether we 'double dip', stay flat or return back to growth. We are still concerned about the massive amount of current and future government borrowing requirements and do not believe there is a simple or quick fix to the US economy's woes.

Treasury Yields at Lifetime Lows

At the beginning of the year we highlighted this concern and felt that long-term US Treasury yields would ultimately move higher in the US. Yields did move substantially higher, Treasury auctions have been poorly received, the US government has borrowed record amounts and the US dollar has fallen. During the same period, yields on the 3-month Treasury bond fell to zero (in November). We would not be surprised if the yields on long-term treasuries continued to move higher into 2010 as short-term rates remained relatively low for at least a couple more quarters.

The March to China Continues

Anthony Bolton, one of the most successful asset managers of all time, has announced he is coming out of retirement and moving to Hong Kong and setting up a fund to invest in Chinese equities. "The (investment) opportunity is simply too great to pass up. My retirement can wait a little while yet." Bolton joins the likes of Jim Rogers who moved to Singapore a few years ago and has full time Mandarin tutors for his children and Michael Geoghegan, HSBC's CEO who is moving to Hong Kong this month. In early 2009 China became the world's largest car market surpassing the US for the first time ever. Towards the end of the year, the Chinese car market was still growing quickly as October car sales were up 77% year over year. In comparison, car sales in the US and most European countries were significantly lower during the same period.

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MASECO has felt this way for some time and we have already adopted very global, less US centric strategic asset allocations and are being vigilant about what we feel is the inevitable reappearance of inflation in the developed world.

Looking Forward

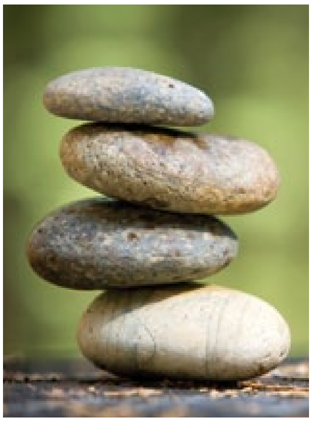
During a recent interview with Fortune magazine, Mohamed El-Erian, formerly the investment chief of Harvard University's endowment fund and currently the CEO and co-CIO of PIMCO, was asked 'What are the most important things that individual investors need to do differently?' He responded by saying 'The average investor has two issues today. First, the average investor is too U.S.-centric. There's a reason for that; the behavioural finance people will tell you that we like the familiar, so we tend to invest in names that we know, that give us comfort. The problem is that you don't want to be too U.S.-centric in a globalising world where the center of gravity is shifting. So the first thing for the average investor to recognise is that the asset allocation of tomorrow is much more global than the asset allocation of yesterday. Second, most of us have been very lucky -- we haven't had to worry about inflation for a long time. We're moving toward a much more fluid world in which, at some point, inflation will come back.'

MASECO has felt this way for some time and we have already adopted very global, less US centric strategic asset allocations and are being vigilant about what we feel is the inevitable reappearance of inflation in the developed world. We believe 2010 will be more challenging for investors as governments and central banks start to withdraw stimulus packages and we believe that regions will perform in less highly correlated manners than during the financial crisis of 2008/09.

We wish you and your families a healthy and happy 2010 and we look forward to helping your family with their financial and investment needs for 2010 and for years to come.

MASECO's Strategic Allocation

We have communicated on several occasions that there is significant academic proof and research to support the fact that investors are compensated for taking certain kinds of risks over a long period of time.



2009 was an exceptional year for our clients' portfolios on both an absolute and relative basis. Almost all of MASECO's major tilts and rebalancing decisions added value, some very substantially, and our investors were handsomely rewarded as a consequence. In general we follow an evidence based approach to investing and believe investors are compensated for taking:

- Equity risk
- Small cap equity risk
- Value equity risk
- Emerging market equity risk
- Credit risk in fixed income (investment grade only)
- Duration risk in fixed income (up to a point)

In addition to overweighting these asset classes, we also believe that:

- Investors are not significantly compensated for overweighting their home country (home country bias).
- The JPM Global Government Bond Index and most other global bond indices, which are made up of the most heavily indebted government bonds globally (Japan, US and European governments), do not provide investors with the best risk-reward global bond portfolio.
- REITs and Commodities provide investors with returns above the rate of inflation and are usually not highly correlated with other asset classes in diversified portfolios.
- Asset classes, and not managers, provide investors with return and most portfolio managers underperform their benchmarks. (see our article on the problems with forecasting in this Investment Quarterly)

How did these Overweights & Views Perform in 2009?

Equity Risk Premium

US Equity Risk Premium: +26.37% International Equity Risk Premium: +35.26%

Dimson, Marsh and Staunton[1] have highlighted in their research on a number of occasions that investors in all developed countries have been compensated for taking equity market risk over a long period of time. Investors were compensated for taking equity risk in 2009. The S&P 500 appreciated 26.46% outperforming US Treasury Bills[2] which appreciated 0.09%. The MSCI World (ex-US) appreciated 35.35% outperforming US Treasury Bills by 35.26%.

Small Cap Premium

US Small Cap Premium: +12.61% International Small Cap Premium: +15.47%

Fama and French discussed in their research of the 'Three Factor Model'[3] that investors are compensated for taking small company and value risk. Investors were indeed compensated for taking small cap risk in 2009. In the US, small cap stocks[4] appreciated 39.07%, outperforming the S&P 500 by 12.61%. International small cap stocks appreciated 50.82% outperforming the MSCI World (ex-US) by 15.47%.

Value Premium

US Value Premium: -7.28% International Value Premium: +2.98%

In the same paper, Fama and French also said that investors were compensated for taking value risk. 2009 was another year of underperformance for value in the US. The MSCI US Value Index appreciated only 19.18% compared to 26.46% for the S&P 500. For most of our investors, however, we were investing in an institutional asset class fund[5] which appreciated 31% as it deviates from the MSCI US Value Index in order to achieve a true value tilt (excludes utilities, REITs and some other traditional value stocks). Outside of the US, the MSCI World (ex-US) Value Index appreciated 38.33% marginally outperforming MSCI World (ex-US) by 2.98%.

Emerging Market Equity Risk Premium: +48.46%

MSCI started tracking equity returns in emerging market equities in 1988 and since then emerging markets have outperformed developed markets on a regular basis but with more risk. The IMF, in their annual research piece entitled 'World Economic Outlook', highlights the stock market capitalisation of different countries and their contribution to world GDP. Emerging markets contributed more than twice as much as the US to the world's GDP, but their stock markets' capitalisation is only about a quarter of the US. At the end of 2008, emerging markets represented 43.70% of the world's GDP but only 10.90% of the world's stock market capitalisation. Meanwhile the US represented only 21.30% of the world's GDP but 43.40% of the world's stock market capitalisation. Consequently we believe that emerging market equities are under-represented in most investors' portfolios and that US equities are over-represented. MASECO's strategic asset allocations are overweight emerging market equities. In 2009 the MSCI Emerging Market Index appreciated 78.29% compared to MSCI World which appreciated 29.83%.

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Fixed Income Credit Premium (Investment Grade only): +21.08%

Investors are usually compensated over a long period of time for taking some credit risk when investing in bonds. Generally investors are not compensated for investing in bonds with significant credit risk (high yield bonds) as those bonds fluctuate significantly in price and the increase in return is not commensurate with the additional volatility. In general we would usually prefer to keep credit risk low in our bond allocation and take risk within our equity allocation. Investors were compensated for taking credit risk and we warned investors about risk in the Treasury markets in our Q1 Investment Quarterly when we wrote: 'The largest bubble may currently be in US Treasuries. Yields are at their lowest level for 70 years, fearful of deflation and depression. The yield on the 30-year Treasury bond stands at 2.91% down from 4.35% in mid-November. If the 30-year Treasury bond yield rose back up to these levels its price would fall by almost 25%' and prompted investors to switch into corporate bonds. Since the middle of January 2009, the price of the 30 year US Treasury bond has fallen by roughly 25% as yields have moved higher. During the year the Intermediate US Government Bond Index[6] fell 1.17% and the Intermediate Corporate Bond Index[7] appreciated 19.91%. Fixed income credit premium also appeared in most international bond markets.

Duration Risk Premium: -10.03%[8]

Investors are usually compensated over a long period of time for taking a small amount of duration (interest rate) risk when investing in bonds. Generally investors are not compensated for investing in bonds with very long maturities as those bonds fluctuate significantly in price and the increase in return is not commensurate with the additional volatility. In general we would usually prefer to keep duration risk low in our bond allocation and take risk within our equity allocation. In 2009 Investors were compensated more for spread compression than for rising intermediate rates. Long-Term US Government Bonds[9] fell by 8.89% while Short-Term US Government Bonds[10] appreciated by 1.14% over the year.

Straying from the Global Government Bond Indices: +17.27%

The major global government bond indices are all market cap weighted and consequently 'invest' in the most heavily indebted countries in the world. Investing in these bond indices would be the equivalent of investing approximately a third of a fixed income portfolio into dollar denominated US Treasury Bonds, a third into Japanese yen denominated Government Bonds (JGBs) and a third into euro denominated government bonds[11]. We do not think that this is a sensible strategy as why would an investor want to lend their money to the most heavily indebted countries in the world? Consequently, we allocate this piece of a client's portfolio to an active manager who seeks to invest in government bonds which may benefit from credit rating upgrades, currency appreciation and interest rate opportunities. In 2009, the Global Bond fund[12] NAV appreciated 19.17% outperforming the JPM Global Government Bond index which appreciated only 1.90%.

REITS: +26.97
Commodities: +26.45%

We include these two asset classes in a portfolio in an attempt to reduce portfolio volatility and maintain the real value of the portfolio. In general, real estate and commodities have not been highly correlated with most of the other components of a diversified portfolio but have provided investors with returns greater than inflation. In 2009, investors were compensated for diversifying into both REITs and Commodities. The Rogers International Commodity Index (RICI), which we invest in for the commodity portion of clients' portfolios, was the best performing of the three major commodity indices in 2009. The RICI appreciated (26.45%) more than either the Goldman Sachs Commodity Index (22.90%) or the Dow Jones AIG Commodity Index (20.09%). In 2009 the unleveraged Global REIT fund we invest in for our clients was up 32.59% and the leveraged Global REIT fund appreciated (79.68%) compared with the NAREIT 50 Index which appreciated 26.97%.[13]

Asset Class Funds: Outperformed

Morningstar recently announced the introduction of a new 'Box Score' report analysing the performance of actively managed US equity mutual fund managers. Morningstar finds that 41% of actively managed funds outperformed their respective indices for the three year period ending June 30th 2009, using a measure of Jensen's alpha. But Morningstar notes that 'once the Fama/French factors are taken into account, active managers' outperformance relative to the indices falls materially.' By the latter measure, only 37% of managers outperformed, and average alpha was negative in all nine style categories.

S&P SPIVA's report suggests this is also the case internationally. S&P reports that only 31% of US large cap core funds for the five-year period ending June 30th 2009 outperformed the S&P 500 Index. Results were even less favourable for non-US markets, where 13% of international funds and 10% of emerging markets funds outperformed their respective benchmarks. We often hear that non-US stock markets exhibit greater pricing errors than the US, supposedly offering a target-rich environment for clever stock pickers. The numbers suggest this is wishful thinking.

Fixed income markets were no less challenging: for the same five-year period, Standard & Poor's found that 22% of intermediate government funds were outperformers, and the number dropped to 11% for high-yield bond funds and only 2% for mortgage-backed securities funds.

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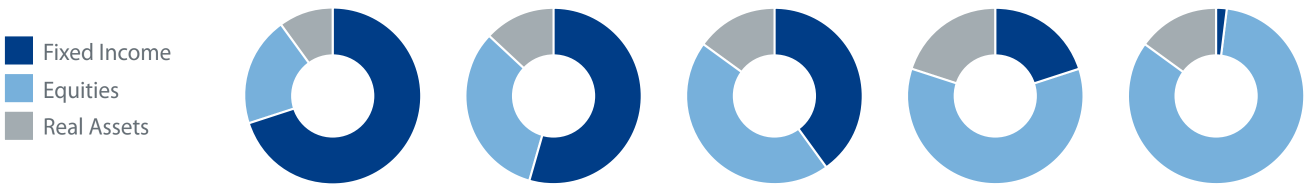
MASECO's Strategic Allocation *cont.*

Summary

2009 was an extraordinary year for MASECO's strategic asset allocations. Almost all of the strategic tilts and investment vehicles outperformed. We recognise that it is unlikely that all tilts and investment vehicles will outperform on an annual basis but we do expect that over the long term our strategic tilts should add value to investors' portfolios.

	Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive
USD Portfolios ($)	18.50%	22.86%	27.01%	32.89%	39.64%
Benchmark[14]	8.92%	13.44%	17.72%	23.54%	29.71%
GBP Portfolios (£)	17.08%	19.78%	23.15%	26.72%	31.13%
Benchmark[15]	1.40%	5.59%	9.72%	15.06%	20.82%
EUR Portfolios (€)	16.93%	20.42%	23.93%	28.13%	33.02%
Benchmark[16]	7.93%	12.12%	16.08%	21.52%	27.04%



NOTES: All of the performance numbers quoted above are in US dollars unless otherwise stated. Also, not all clients have exactly the same portfolios or the same investment vehicles. Depending on a client's risk appetite, time frame, implementation strategy, currency reference or other reasons, their portfolio may differ from our Strategic Allocation. That being said, all of our Strategic Allocations do tilt and slant as described above and would have benefited from the outperformance of many of these slants last year. It is also important to note that there are often times when some investment vehicles mentioned above are not recommended to clients. The main reason is usually because the investment vehicle described is not tax efficient or may be deemed unsuitable for a client and an alternative is used.

[1] Elroy Dimson, Paul Marsh and Mike Staunton (2002). Credit Suisse Global Investment Returns Sourcebook 2009 and Triumph of the Optimists, Princeton University Press.

[2] US Treasury Bills, DFA (2010).

[3] Fama, Eugene F.; French, Kenneth R. (1992) "The cross-section of expected stock returns" Journal of Finance.

[4] MSCI US Small Cap Index.

[5] DFA Tax-Managed US Marketwide Value Fund.

[6] Morningstar Intermediate US Government Bond Index.

[7] Morningstar Intermediate Corp Bond Index.

[8] US Fixed Income Market.

[9] Morningstar Long-Term US Government Bond Index.

[10] Morningstar Short-Term US Government Bond Index.

[11] JPM Global Government Bond Index.

[12] Templeton Global Bond Fund.

[13] DFA Global Real Estate Fund and ING Clarion Global Real Estate Fund.

[14] USD Benchmark Composition: Citi Treasury Benchmark 5 Yr, JPM Global GBI, MSCI AC World, S&P Global REIT, Morningstar Long-Only Commodity.

[15] GBP Benchmark Composition: Citi UK GBI (3-7 Yr), JPM GBI Global (ex-UK), UK FTSE All-Share, FTSE World, S&P Global REIT, Morningstar Long-Only Commodity.

[16] EUR Benchmark Composition: Citi WBIG Govt, JPM GBI Global, Euro Stoxx 50, FSTE World, S&P Global REIT, Morningstar Long-Only Commodity.

Economics: A Bipolar Recovery

As signs of a global economic recovery mount, the key question facing financial markets at the start of 2010 is the nature of the expansion and the likely reaction of policy-makers.

While the recovery seems well established in a number of emerging countries – including key players such as China, India and Brazil – and in some developed ones closely linked, via exports, to them – Australia, Canada – doubts remain about the solidity of the recovery in most of the developed world.

Those doubts appear well placed. The extraordinary measures introduced by governments in late 2008 and early 2009 have prevented the collapse of the financial system and have limited the associated recession in the real economy. But many of the underlying imbalances – high indebtedness ratios of households and, in some countries, the corporate sector – remain unresolved, and its digestion will take quite some time. Moreover, the Great Recession has left a legacy of unsustainable public sector deficits and going forward governments will have to tighten their belts.

This divergence between emerging and developed economies reasserts the phenomenon observed since the start of this century; namely, the increasing role of emerging countries as the main drivers of global economic growth. Moreover, unlike on previous occasions, emerging countries entered the 2008-09 global cyclical downturn in a relatively comfortable position – with low inflation and large external surpluses – and were able to react forcefully with stimulative measures. This prudence (in contrast with the large debt build-up in developed economies) is now a major relative advantage.

The End of Stimulus

In developed countries, the key near-term uncertainty is the sustainability of the recent upturn as the effect of the stimulus measures fades and the inventory cycle runs its course. Given the usual lags, the maximum impact from monetary easing will happen early this year, after which the beneficial effect will start to diminish. In addition, the fiscal expansion may have already reached its peak in most countries; in fact, financial markets are forcing an increasing number of governments, especially in Europe, to start fiscal consolidation in 2010. Finally, the expansionary effect on real incomes of last year´s commodity price decline is gone by now.

The banking sector is another potential drag on the recovery. The major central banks have started to exit from some of the unconventional measures introduced after the Lehman collapse (quantitative and credit easing, extra liquidity for the banking system) and governments also will, at some point, unwind the banking support measures (recapitalisations, debt guarantees, purchases of toxic assets). Regardless of how fast all that takes place, banks will probably remain focused on rebuilding their solvency ratios and reducing their funding gaps. The implication is that the supply of bank credit to households and firms will remain scarce. This is not a problem for large companies (with access to capital markets) but is a major constraint for households and small firms.

With the prospect of a gradual economic upturn plus all those uncertainties in mind, central banks should maintain a very accommodative monetary stance. Core inflation is low and falling, and even if a vigorous economic recovery in emerging countries boosts commodity prices, inflation expectations in developed countries are very well anchored. Against this backdrop, only massive growth surprises would convince central banks to start the tightening cycle before end-2010 – at the earliest.

Where is Potential?

Looking beyond the near term, one of the legacies of the debt-induced expansion of 2003-07 and the ensuing financial crisis may be a lower potential growth in the affected economies. As the theory goes (and evidence of past financial crises tends to confirm), the inevitable restructuring of the banking sector eliminates one of the major sources of growth during the expansion (i.e., debt-financed consumption and real estate investment) and may even reduce the availability of credit to firms and households for other spending (business investment) well beyond 2010.

In the present circumstances characterised by a hostile atmosphere against banks, such a prospect looks realistic. Having peered over the edge of the precipice, policy-makers and regulators are determined to curb future excesses in the banking sector. Details of the new regulations will emerge in coming months but the general thrust is clear: Higher Basel II capital requirements (including a higher proportion of common equity), lower overall leverage ratios, stronger liquidity positions and more stringent provisioning. In summary, regulators want banking to become a "dull" business again, with more stability and probably, lower profitability. Disintermediation will be back in vogue.

If confirmed, a lower potential growth rate has important implications for financial markets. Domestic income growth (including corporate earnings) will be on average slower than in pre-crisis times but, short of an unlikely inflationary spiral, interest rates will tend to be historically low on average over the business cycle as well. Hopes for dynamic earnings growth are, once again, placed on emerging markets, where potential growth is high and has not been compromised by the financial crisis in the developed world. The good news is that an increasing share of corporate profits of listed companies in the U.S. and Europe derive, directly or indirectly, from emerging markets.

Currency Conflicts

The growth divergence between emerging and developed countries suggests that emerging market currencies will continue to strengthen. But the voyage may be rough in the near term. Some hints of trouble are already visible. To rebalance the composition of demand in favour of exports, the U.S. needs an orderly depreciation of the dollar, ideally against fast-growing Asia. However, China (the key player in the region) is reluctant to allow its exchange rate to rise until its own expansion is well secured on domestic grounds and less dependent on exports. (Even as this shift happens, China will probably allow just a gradual appreciation of the yuan). Meanwhile, European policy-makers are fretting about the possibility that the euro bears the brunt of a possible run on the dollar.

There is no obvious solution for these policy discrepancies. The G-20 is not yet a well established forum for macro-economic policy coordination (it is mainly dealing for now with financial regulation). Without a coordinated approach to currency management, the risk of overheating in Asia (where interest rates are too low) and a stalling recovery in the U.S. and Europe (where exchange rates should weaken) may well fuel nervousness in currency markets, with potentially very wide exchange rate fluctuations that could mask temporarily the long-term trend towards a weaker dollar and stronger Asian currencies. International policy conflicts typically are a recipe for exchange rate tensions that can easily dominate asset returns in global portfolios.

Equities: Once More unto the Breach...

2009 witnessed one of the strongest equity recoveries of all time. Following extensive government stimulus packages in the US and the UK the S&P 500 and FTSE 100 responded to the call to arms and appreciated by 19.67% and 18.66% respectively. In fact returns exceeded 25% in 41 out of 45 countries tracked by the MSCI.

However, taking a longer-term view, the S&P 500 started the last decade at 1,394.46, closing at 1,115.10, with the FTSE 100 opening at 6,268.50 and closing at 5,412.88. Over the last 10 years an investor who bought and held equities would have made little or no money[1]. Stocks have in fact lagged US Treasury bonds by a compounded average of 8.6% per year over the last 10 years. The short-term bounce, whilst creating a warm feeling, really only illustrates how far equities fell in 2008. Since 1926 the S&P has returned an average of 4.3% more per year than Treasury Bonds and, looking at all the rolling 10 year periods since 1926, stocks have outperformed bonds 86% of the time. If one considers the performance of the S&P 500 after a 10 year period of negative returns, the S&P 500 has delivered positive returns over a five and ten year basis. On average the S&P 500 has returned 9%.

As Mark Twain stated: 'History however doesn't repeat itself – at best it sometimes rhymes'.

A Bubble Emerging?

Emerging markets did especially well in 2009. The total return for the MSCI Emerging Markets Index (in US dollars) was 79.02% posting its largest ever annual return since the inception of the MSCI index in 1988. Some of this return however was due to general dollar depreciation versus emerging market currencies. The BRICs were big winners last year with Brazil's stock market appreciating 83%, Russia 113%, India 81% and China 62%. The BRICs outperformed their developed peers, highlighting a continuing shift in investor appreciation for emerging markets as a whole.

When investing in emerging markets, clients have to ask themselves which markets they consider to be categorised as 'emerging'. Should they leave this decision to the leading index providers, the media or step out and venture into markets as they deem fit on an ad hoc approach? At MASECO we invest in emerging markets using a disciplined approach ensuring that qualitative and quantitative factors are considered before allocating capital to a particular country. Currently a maximum of 12.5% is allocated to a particular country as a risk management tool to control country specific volatility.

Money Flows Tell the Tale

$75bn flowed out of US equity mutual funds in 2009 and into emerging market equity mutual funds. It cannot be ignored that the emerging markets were the main driver behind the world's equity performance which is unsurprising given their potential for growth and strong relative GDP growth. We have described repeatedly last year how we have been overweight emerging markets from a strategic asset allocation perspective and we still maintain this overweight over the medium term. In large part we believe in this tilt due to favourable demographics, growth prospects, the fiscal situation and the under representation of emerging markets in global equity indices such as the MSCI World index.

Europe also performed well in both absolute and relative terms in 2009 with the DJ Euro Stoxx 50 appreciating 21%. Even emerging Europe with its growing debt problems managed to post impressive returns. The Polish WIG appreciated 47%, the Prague ČEZ appreciated 30% and the Budapest BUX leapt 73%. 2009 was the year that risk aversion abated and many of the riskiest asset classes or markets returned substantial sums.

"No Return to Boom & Bust"[2]

As highlighted in our Q1 Investment Quarterly regarding behavioural finance's emotional cycle, we can begin to notice that investors in equity markets are no longer fearful of an equity collapse and that some investors may be entering the 'pleasure' stage of investor emotions (see chart bottom left). Globally, equity indices all performed well in 2009 and the VIX and VDAX (measures of volatility in equity indices) are both much lower than at the beginning of 2009, confirming risk appetite has returned to equity indices are both much lower than at the beginning of 2009, confirming risk appetite has returned to equity markets. At MASECO we have no way of timing the tops and bottoms of these emotional cycles and rely on discipline, structure and an adherence to the investment philosophy to invest appropriately across the business cycle.

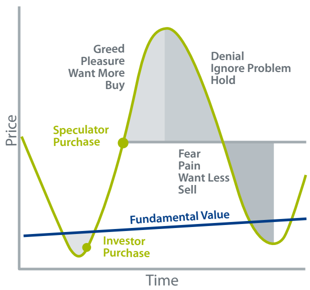
Death & Taxes

On January 1st 2011 the US tax cuts which were passed near the beginning of the century are due to expire. The US top rate of Income tax rate is due to increase to 39.6%, with the lower marginal tax rates remaining at current levels. Capital gains and dividends are likely to be taxed at 20%. When tax rates were adjusted about a decade ago investors expected a flight to equity participation and also dividend paying stocks. In reality any correlation here is probably coincidental and we would not expect to alter an equity-based strategy based on tax rates. It might be worth considering locking in significantly appreciated gains prior to the tax increase if they cannot be offset against losses in future years.

Rebalancing

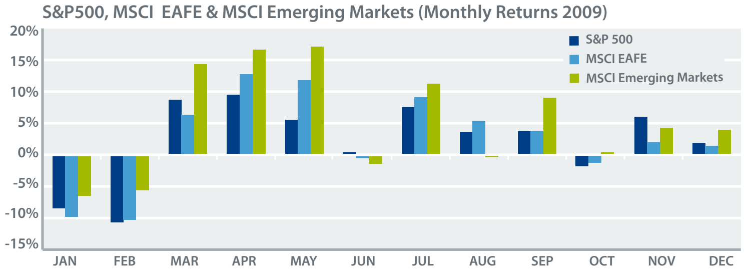
The best strategy when investing in a volatile risk asset is to rebalance when the portion of your portfolio in that asset class has either become too large or small when compared to your strategic asset allocation. For equity investors who rebalanced when the markets were very low in Q1 2009, the equity portion of their portfolio may now be much greater than their strategic asset allocation would recommend. In such a case, it would be time to reduce exposure to equities and rebalance back to your strategic asset allocation.

A speculator's emotions cause him to buy high and sell low



SOURCE: IRVINEHOUSINGBLOG.COM (2006)

S&P500, MSCI EAFE & MSCI Emerging Markets (Monthly Returns 2009)



SOURCE: DFA RETURNS (JAN 2010)

[1] 10 Year Returns (% pa):
FTSE 100 PR = -2.8%, TR = 0.3%.
S&P500: PR = -1.65%, TR = 0.42%.
Source: FTSE.com and S&P.com (accessed Jan 2010).

[2] Gordon Brown Sept 25th 2000.

Fixed Income: Tightening Seatbelts

The US Federal Reserve recently commented that it expects inflation to remain subdued for some time thus implying that it will maintain its stance of loose monetary policy for a while yet.

The Fed

The US Federal Reserve recently commented that it expects inflation to remain subdued for some time thus implying that it will maintain its stance of loose monetary policy for a while yet. For bond holders the question is: when will short term rates rise and if so, how far? At MASECO, we believe that not even Ben Bernanke knows the answers to these questions. What is for certain is that other barometers used by market participants seem to be implying inflationary expectations – strong gold and the weak dollar. When setting monetary policy will the Fed focus solely on unemployment and spare capacity and ignore inflationary expectations that appear in other asset classes? Investors will again become bemused as to which condition of Fed policy carries the most weight.

The Bureau of Labour Statistics data on productivity and unit labour costs tells a fascinating story. There is a significant correlation between inflation and unit labour costs in the US, so low labour costs in developing countries are preventing inflationary pressures at the moment in the US and it is difficult to see demand-pull inflation in the short term.

As a consequence, we expect short term interest rates to remain low well into 2010 and for Quantitative Easing to cease in the upcoming quarters in many developed countries. It is also unlikely that the Fed will spook the bond market with surprise rate rises and we expect that central banks will telegraph their intentions well in advance of taking action.

The Yield Curve

In the US, the yield gap between the 2 year Treasury and the 10 year Treasury has widened to 286bps. This is the largest gap in history as the Fed signalled it would hold short term rates steady near zero percent for most of 2010. Looking back at historical tightening cycles in 1994 and 2004 the 2/10 year gap showed signs of flattening 10 months prior to the Fed's first rate hike. The gap historically flattened to approximately 70bps and is commonly known as a 'bear flattener' (where the 2-year yields rise faster than the 10 year yields). Currently this 'bear flattening' is not evident in the US government bond market.

Supporting the notion that short-term interest rates could stay low for an extended period is that the Taylor Rule (adjusted by Dr. Robert Barbera of ITG) is currently implying a negative Fed funds rate. The Taylor Rule stipulates how much central banks should change interest rates in response to divergence in inflation from target inflation rates and actual GDP from potential GDP.

Squeezing Credit

A year ago we were highlighting the case for credit to be included in clients' portfolios. Credit looks cheap when rates are high and spreads are wide - this time last year the 'spreads' were at exceptionally wide levels. We wrote: 'Recently high-quality credit spreads hit their widest level for 75 years (or another way of putting it – they are at their cheapest since the Great Depression… The largest bubble may currently be in US Treasuries. Yields are at their lowest level for 70 years.' Roll forward twelve months and we look at a scenario where rates are low and spreads have narrowed and intermediate investment grade bonds have returned almost 20%. Credit therefore does not look so attractive and returns will mainly come from the more modest yields with the headwinds being increasing rates and the risk of another economic downturn. The speculative gain has been made and going forward investors should expect more modest returns. Interestingly Moody's estimates that the trailing 12 month issuer default rate at the end of the third quarter was 13% and their future estimate is for defaults of only 4-5% in the next 12 months.

The major risks, in our opinion, for the credit markets in 2010 are with the central banks. If they withdraw liquidity too quickly the economy may fall into a double dip recession. Higher rates are obviously not good for bond investors but generally coincide with a healthier economy – which supports credit. Spreads for investment grade and high yield credit are currently above their long term averages of approximately 180bps and 700bps respectively.

When one looks at the current relative valuations between credit and cash it paints an interesting picture. If one is willing to accept the risk associated with intermediate investment grade credit then they will be compensated with an extra yield of 4.5% (on the US curve). On a historical perspective, this yield gap is attractive and investors can still be rewarded for taking this limited duration and credit risk.

Fixed Income: Tightening Seatbelts *cont.*

Morgan Stanley suggested that if Britain ends up with a hung parliament in the spring this could cause a fiscal crisis with the pound weakening further and gilt rates rising.

Sovereign Default Lines

During the second quarter last year we highlighted the credit risk associated with certain sovereign credits. This risk continued to materialize as S&P stated that it was reassessing the ratings of Spain, Portugal and Ireland while downgrading Greece`s sovereign credit rating from 'stable' to 'negative'. Dubai World also hiccupped on its debt obligations only to get partially bailed out by its wealthier cousin Abu Dhabi.

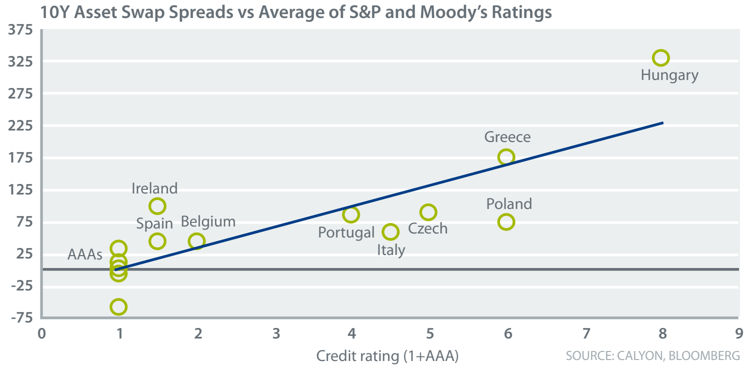
These scares have been small but what would happen if a member of the euro area could no longer finance its debt?

Greece ran persistent deficits during the good times and its new government stated that this year's budget deficit would be more than twice previously advertised.

The European Treaty contains a 'no bail-out' clause that prohibits one country from assuming the debts of another. It is worth casting ones minds back to 1975 when New York City defaulted or looking at California today. Would a default on municipal debt cause a run on the dollar? New York's bailout was punitive and resulted in tax rises and a reduction in expenditure – this enabled the President to claim that 'New York bailed itself out'.

Sovereign credit default swaps are a good indicator of the market's perception of sovereign credit but unlike corporations sovereigns have the ultimate debt cure of taxing a captive audience. This makes default a remote possibility but arguably puts significant pressure on currencies or economic blocs.

10Y Asset Swap Spreads vs Average of S&P and Moody's Ratings



SOURCE: CALYON, BLOOMBERG

Morgan Stanley suggested that if Britain ends up with a hung parliament in the spring this could cause a fiscal crisis with the pound weakening further and gilt rates rising. At MASECO we would suggest that whilst the conclusion has got merit we would encourage our clients not to put much emphasis on cause and effect in advance of intertwined market movements.

Emerging Market Debt

During 2009 Emerging Market debt spreads narrowed from 700bps to 320bps over Treasuries. Generally emerging markets are sitting on current account and fiscal surpluses that look significantly better than many of their developed market cousins. It will be interesting to see how the Emerging Markets debt market develops as their economic situation becomes increasingly robust when compared to the developed world`s debt ridden debt markets. One would also expect upward pressure on currency or at least the continued pressure on currencies that are pegged to the dollar (China, Saudi Arabia, Hong Kong, etc.)

Municipals

In 2008 municipal bond prices fell substantially and were fairly inexpensive at the beginning of 2009. A year ago we wrote: 'The municipal market is looking inexpensive as well versus the Treasury market'. Since then, municipal bonds appreciated significantly driven by reduced supply and capital flows in spite of budgetary pressures and credit downgrades. In fact municipal bonds recorded their third best year in twenty according to a Merrill Lynch index.

Multiple forces remain at work in the municipal bond market. Over the last year state finances have deteriorated and the strategy of wrapping poor credit with a AAA banner for a meagre insurance premium is the practice of days gone by. Even with these headwinds municipal bonds have rallied hard from their lows.

Moody's recently downgraded Illinois, the second lowest rated state after California and some have argued that unemployment in California will stay in the double digits until 2012. Historically the rates of defaults for munis have been tiny as like sovereigns taxes can be raised to bolster the balance sheet. That being said, we don't really know what would happen if a major state like California were to default on their debt and we are obviously not eager to find out.

Municipal bond prices have been supported by the development of the Build America Bond (BAB) programme. Whilst this has generally been the territory of the institutional investor it has provided the municipalities with much needed support. The issuance of the taxable BAB's has not significantly increased the supply of tax exempt paper which could stabilize municipal bond prices. Tax revenues may also increase in 2011 if the economy improves which would help the finances of municipal bond issuers in general and further stabilize municipal bond prices.

Summary

Fixed Income investors have to be more vigilant when allocating capital in 2010. The goldilocks scenario has disappeared. Running fixed income portfolios in the wake of a global rate hiking cycle is a difficult affair. We therefore will stick to our knitting and continue to employ a disciplined fixed income strategy that does not extend itself in the credit or the interest rate environment.

Currency: A Look Back

2009 was another volatile year for currencies. After getting beaten down for most of 2008, sterling rebounded and was the best performing major currency in the world. It started the year at 1.466 against the US dollar and appreciated by over 10% to end the year at 1.615[1]. Against the euro, sterling gained over 8% and appreciated against the other major currencies.

The Euro

The euro had a tumultuous year, starting at 1.393 against the US dollar, and peaking at over 1.50 in mid November (a 15 month high) before falling back to 1.435 at the end of the year[2]. Specifically in December, the euro came under pressure amid concerns of Greece's fiscal position and the health of Eurozone banks, as regulators expressed concerns about Austria's fourth largest bank capital position.

US Dollar

After peaking in early March, then falling by roughly 20%, the dollar finally turned around and appreciated by about 4% in December (on a trade-weighted index). As the US dollar has fallen, so has the Chinese renminbi, which is pegged to the US dollar. This has created concern globally and especially in Asia where most currencies have significantly strengthened against the US dollar (and consequently the renminbi). This has essentially made Chinese exports cheaper compared to neighbouring Asian countries, thus hurting the economic growth in these countries. In mid-November China's central bank acknowledged a case for a stronger renminbi and took a welcomed step when it stated that it would take into consideration 'capital flows and major currency movements' when considering its currency.

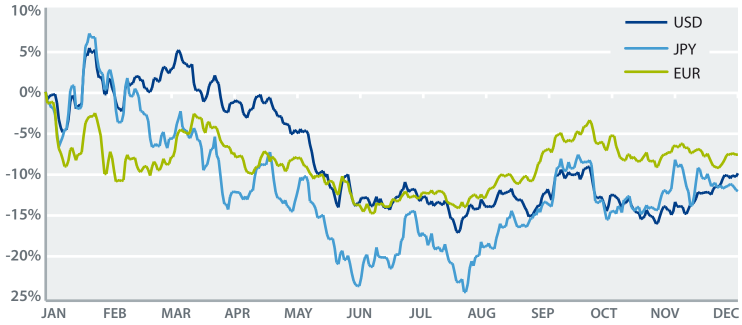
US Dollar as a Reserve Currency

As the dollar has fallen, many governments and other market participants have voiced concern about the US dollar as a reserve currency. China has been purchasing raw materials globally with some of its reserves and India and Sri Lanka purchased significant amounts of gold in late November from the IMF to diversify their central bank holdings away from the dollar.

Asian & Emerging Markets

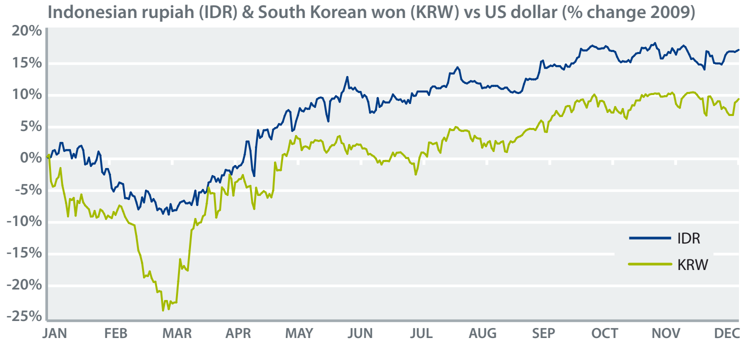
The story for the year was the strength of the Asian (ex-Japan) and emerging market currencies. The Indonesian rupiah was Asia's best performing currency for 2009 as it appreciated more than 16% against the dollar[3]. The South Korean won was a close second as both South Korea and Indonesia saw massive inflows from foreigners into both their equity and fixed income markets. Asian central banks intervened in currency markets recently to stem the appreciation of their currencies against the dollar and the renminbi. Many of the region's currencies are at or near multi-year highs. These include the Indian rupee, Indonesian rupiah and the South Korean won.

US dollar, euro, Japenese yen vs sterling (% change 2009)



DAILY AVERAGE RATES, OANDA.COM ACCESSED JANUARY 11TH 2010

Indonesian rupiah (IDR) & South Korean won (KRW) vs US dollar (% change 2009)

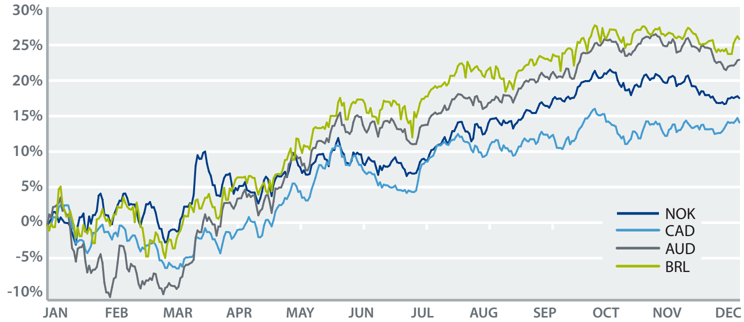


DAILY AVERAGE RATES, OANDA.COM ACCESSED JANUARY 11TH 2010

Currency: A Look Back *cont.*

For most of our investors we accept global currency exposure when investing in global equities or global government bonds through an active global government bond fund.

Norwegian krone, Canadian dollar, Australian dollar, Brazil real vs. US dollar (% change 2009)



DAILY AVERAGE RATES, OANDA.COM ACCESSED JANUARY 11TH 2010

Commodity Countries

Many of the commodity and oil-producing countries (Canada, Australia, Brazil, Norway, etc.) saw their currencies appreciate significantly against the dollar and the euro to multi-year highs as commodity prices rebounded and as market participants appreciated that many of these economies were more fiscally sound than some large, more indebted, countries.

Investing in Global Currency Markets

For most of our investors we accept global currency exposure when investing in global equities or global government bonds through an active global government bond fund. The global government bond fund invested in by our clients appreciated 19.17% last year in US dollars (6.33% in sterling) in large part because it was overweight Asia and Latin American currencies. After a poor start to the year, the manager reiterated his long-held strategy and view. At the time he was overweight yen and was shifting to South Korea, Brazil, Australia, Indonesia and Mexico all of which had significantly depreciated in January and February and then promptly substantially rebounded.

A Look Back at 2009

By and large our concerns about a weaker US dollar, sterling and euro against Asian (ex-Japan) and commodity countries (mostly net creditor countries) started to materialise.

In our Q1 Investment Quarterly we discussed the massive amount of quantitative easing in the US, Europe and the UK and wrote 'we expect countries that print money to see their currency depreciate.'

In the second quarter we wrote specifically about the potential for appreciation in the Mexican peso, the Norwegian krone and the South Korean won and other Asian currencies and wrote: 'We believe that Asian currencies will outperform European and US Dollar currencies over the medium to long term.'

In the third quarter, shortly prior to India and Sri Lanka purchasing gold, we discussed the US dollar as a global reserve currency and wrote: 'We would not be surprised if the US dollar continued to face significant challenges and if its value slowly eroded as the world adjusts to the new world of net creditor countries and their search for an alternative to the dollar as the sole global currency reserve.'

Looking Forward

We expect that the US government will continue to print money and that the dollar will continue to struggle as the US economy tries to inflate itself out of its debt problem. Whilst we don't expect this to be in a straight line we diversify currency exposure, liability match and use an active manager to work through this and other trends. That being said, there is currently no real alternative at the moment to the US dollar as a world reserve currency and we still do not see a disorderly depreciation of the dollar.

Although currency is difficult to predict and can be very volatile, we still believe that countries with prudent fiscal positions who are growing and not issuing significant new amounts of debt will continue to see their currencies appreciate against less fiscally responsible countries. We do not see how some of the most indebted countries such as Japan, the US, the UK and some European countries can easily right their poor fiscal positions and we believe that in general these currencies as a group may continue to lose value on a relative basis. That being said, we are acutely aware of the rising risk of protectionism by some governments and the effect that the withdrawal of central government stimulus packages will have on various currencies in 2010.

[1] Reuters Closing Spot Rates, FT.com accessed January 15th 2010.

[2] Reuters Closing Spot Rates, FT.com accessed January 15th 2010.

[3] Daily Average Rates, OANDA.com accessed January 11th 2010.

Commodities: All That Glitters

Gold Price 2009

SOURCE: MORNINGSTAR (2010), LONDON PM FIX, Jan 1 2009 – Dec 31 2009

2009 was a year for gold bugs as the price rose 25.04% reaching a high of $1,212.50 on December 3rd. This was mainly caused by the weak US dollar, inflation fears and near zero returns on cash providing a low opportunity cost for holding gold as investors sought alternative investment returns. A curious by-product of the rise in the price of gold is the proliferation of new businesses offering to buy gold by mail order as evidenced by increased advertising on TV by companies such as cashforyourgold.co.uk and cash4gold.com. Additionally, London's most famous department store, Harrods, is now also buying and selling gold.

By the end of the year gold had retreated to $1,087.50 and the question now is: where is the price of gold heading this year? Valuing gold is complicated – it has few uses other than for jewellery, some industrial applications and investment. As Warren Buffet once said "Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. Anyone watching from Mars would be scratching their head." Gold bulls point to limited supply and increasing demand from central banks (witness the purchase of 200 metric tons of gold by the Reserve Bank of India in November followed by a smaller purchase by Sri Lanka) as well as inflationary concerns caused by quantitative easing. Gold bears highlight the lack of investment return available to investors and the propensity over time for gold prices to fluctuate within a large band (or to constantly bubble).

Analysts differ in their future predictions for gold and the range of prices quoted for the end of 2010 is between $850 and $1,450 – either a 30% fall or a 30% increase based on the 2010 starting price. 2010, like 2009, will be a remarkable year for gold either way.

A curious addendum to this section: an article in The Times in March 2009 suggested that there had not been an independent audit of the $137 billion gold stockpile at Fort Knox in the USA since the era of President Eisenhower[1]. Consider the effect on the price of gold (and global markets) if it turned out that the real amount of bullion was considerably lower.

Copper Pots & Pans

Copper prices increased 19.72% in the fourth quarter and 153.16% overall in 2009. The main (and well-documented) driver for this has been the increased demand from China. However, the price spiked to a 15 month high of $7,375.00 a tonne at the end of 2009 as strikes threatened production in Chile. Prices are expected to continue to rise as the global recovery gains momentum; however, a rise in interest rates by the Federal Reserve that leads to a strengthening of the US dollar could put a brake on this. Copper is widely used in industrial applications and is often seen as a bellwether for the general health of the economy as can be seen by its performance in 2009. Continued growth in global GDP should see a continued, though less prolific, rise in copper prices.

Copper Price 2005 – 2009

SOURCE: MORNINGSTAR (2010), LME, Jan 1 2005 – Dec 31 2009

[1] Chris Ayres (2009) Is there any gold inside Fort Knox, the world's most secure vault? The Times. London, 28th March.

Poor weather, both actual and predicted, was the primary cause for an increase in the prices of a number of soft commodities...

Anyone for Tea – Isn't the Weather Awful?

Poor weather, both actual and predicted, was the primary cause for an increase in the prices of a number of soft commodities – tea, cocoa and sugar – making your average cup of tea with chocolate biscuit on the side more expensive, especially if you take it with a couple of lumps of sugar.

Over the course of 2009 tea prices hit record levels with the United Nations Food and Agriculture Organisation tea composite reaching a high of $3.18/kilo in September compared with an average price of $2.38 in 2008. Cocoa hit its highest London price in 32 years and white sugar prices continued to trade near record levels with LIFFE March up 0.7% to $673 a tonne while ICE March raw sugar added 1.5% to 26 cents a pound.

The weather played a large part in driving the prices for these commodities. Droughts in India, Sri Lanka and Kenya caused tea shortages that pushed up prices in 2009 but this may also create a future over-supply as farmers may increase planting and production in 2010. There are concerns that this year's El Niño could hit cocoa supplies from Indonesia and Ecuador and that the Harmattan (the dry, dusty wind that blows from the Sahara) could jeopardise a strong-flowering and therefore damage production in West Africa which produces two thirds of the world's cocoa. Typically in an El Niño year global production dips by 5% and this has helped push prices up throughout 2009 and may well continue to contribute to increased prices in 2010 as output for 09-10 could lag behind demand for the fourth year running.

As an aside, production in West Africa is in decline as farmers switch to rubber to seek higher returns. Poor husbandry and disease have particularly affected farmers in the Ivory Coast who are reluctant to invest in new cocoa plants as there is a 3-4 year wait before a plant yields anything and there can sometimes be several more years to wait before it generates a profit. The Ivory Coast alone currently produces 40% of the world's cocoa so it will be interesting to review this in future years.

Shipping

The Baltic Dry Index (a daily average of prices to ship raw materials) started 2009 at 774 peaking at 4,661 on 19th November and closing the year at 3023 – still a long way off the high of 11,793 on 20th May 2008. This indicates that the cost of transportation of commodities is still a long way off pre-credit crunch highs despite increasing nearly fourfold since the start of the year and possibly that there will be continued demand for commodities into 2010.

Sources: FT.com (Dec 31 2009) Markets Data, unless specified otherwise.

The Power of Forecasting

As an investor, which broadsheet, investment bank or asset manager should one listen to? All have their vested interests which often can be quite disguised.

As I entered the holiday season I was looking forward to the annual deluge of market forecasts that were to come across my desk from the many self proclaimed experts and commentators. I find myself sitting here during the New Year lull imagining that I was a client with the weekend papers in front of me. As expected I have stumbled across an article titled 'FTSE forecasts year-end 2010'. The forecasts range from 3,980 to 6,000. The FTSE is currently trading at 5,412.88. Most of the rationales behind the various predictions are feasible and some may actually transpire. Behind the predictions lie valid economic arguments, but which one will prevail?

I also looked back at The Economist's predictions in 2007 for 2008 and in 2008 for 2009. They missed the global financial crisis in 2008 but Philip Coggan (their capital markets editor) correctly predicted that 2009 would bring more stability and a return towards relative normality. As an investor, which broadsheet, investment bank or asset manager should one listen to? All have their vested interests which often can be quite disguised. How exciting would a broadsheet be if it didn't provide you with insight, analysis and predictions? It is part of the human psyche to look forward.

If it is understood that most financial commentators are trying to make things sound exciting so viewers/readers are entertained and are not held accountable or are compensated for the accuracy of their comments or predictions, perhaps it is better to look elsewhere for insight into the future. Perhaps it is worth looking at what the professionals who are compensated and accountable for their comments and predictions are saying, namely endowments, pension funds and other institutional investors. By sheer chance, I happened upon an interesting article over the holidays that wouldn't appear in the bestsellers lists. It appeared in the latest addition of the Financial Analysts Journal and was titled: 'Absence of Value: An analysis of Investment Allocation Decisions by Institutional Plan Sponsors'. Prior to reading the article, one would have thought that the experts making allocation decisions for the largest institutions would be at the top of their field for a reason – the ability to add value.

The conclusion of the article was that the typical institutional portfolio is suffering due to an undisciplined and backwards looking investment strategy. In general, investments that institutions sold outperformed new investments that replaced the old ones. The problem is so widespread and common that the authors estimate the cost of this strategy was over $170 billion over rolling five year periods. This is prior to the transaction costs of re-balancing which the authors estimate may double the cost of these poor decisions.

My newspaper with financial predictions is heading for the log fire with the last remnants of the wrapping paper, but I would like to draw your attention to an excellent paper published in the Quarterly Journal of Economics (1970) – The Market for Lemons. The basic premise behind this paper is that goods or services (in our case investment 'alpha' is the 'lemon') are sold with a label of quality and it is difficult for the purchaser to assess the quality. Investment products are generally sold under the assumption that historical performance (alpha) can be repeated. As I have read in the papers this holiday season, it seems even the experts have a difficult time achieving this let alone mere mortals.

It is all a matter of perception.

Economic Forecasting in an Uncertain World

"As an economist and policymaker, I have plenty of experience in trying to foretell the future, because policy decisions inevitably involve projections of how alternative policy choices will influence the future course of the economy. The Federal Reserve, therefore, devotes substantial resources to economic forecasting. Likewise, individual investors and businesses have strong financial incentives to try to anticipate how the economy will evolve. With so much at stake, you will not be surprised to know that, over the years, many very smart people have applied the most sophisticated statistical and modeling tools available to try to better divine the economic future. But the results, unfortunately, have more often than not been underwhelming. Like weather forecasters, economic forecasters must deal with a system that is extraordinarily complex, that is subject to random shocks, and about which our data and understanding will always be imperfect. In some ways, predicting the economy is even more difficult than forecasting the weather, because the economy is not made up of molecules whose behavior is subject to the laws of physics, but rather of human beings who are themselves thinking about the future and whose behavior may be influenced by the forecasts that they or others make. To be sure, historical relationships and regularities can help economists, as well as weather forecasters, gain some insight into the future, but these must be used with considerable caution and healthy skepticism."

Ben S. Bernanke Address at the 2009 Commencement of the Boston College School of Law, Newton, Massachusetts, May 22, 2009.

Indicators

GDP Growth Rate %			
	Quarter*	2009 E	2010 E
US	2.20	-2.50	2.70
UK	-1.20	-4.50	1.30
Euro Area	1.50	-3.80	1.20
Japan	1.30	-5.40	1.50

*% change on previous quarter, annual rate

SOURCE: ECONOMIST POLL (DECEMBER 30, 2009)

Inflation %			
	Latest	Year Ago	2009 E
US	1.80	1.10	-0.40
UK	1.90	4.10	2.10
Euro Area	0.50	2.10	0.40
Japan	-1.90	1.00	-1.30

SOURCE: ECONOMIST POLL (DECEMBER 30, 2009)

Equity Summary (in local currency)					
Index	Value	Quarter (%)	1 yr (%)	5 yr (%)	10 yr (%)
S&P500	1115.10	6.04	26.46	0.42	-0.95
Russell 1000 Value	349.68	4.22	19.69	-0.25	2.47
Russell 2000	1554.25	3.87	27.17	0.51	3.51
EAFE $	1580.77	2.18	31.78	3.54	1.17
EAFE Value $	2726.25	0.28	34.23	3.36	3.53
EAFE Small $	142.44	-1.03	46.78	3.50	–
FTSE 100	5412.88	5.43	22.07	2.37	-2.44
FTSE 250	9306.89	2.31	50.64	9.03	6.70
MSCI UK Value	4004.92	2.40	21.43	3.85	1.69
MSCI Europe	88.28	5.18	31.60	2.81	-1.62
MSCI Europe Value	99.43	2.80	33.45	1.79	0.06
MSCI Europe Small	157.15	2.23	59.50	4.80	–
MSCI Emg. Mkt. $	989.47	8.55	78.51	15.51	9.78
MSCI AC World Index $	89.67	4.25	31.51	1.03	-1.29

SOURCE: MORNINGSTAR (2010)

Fixed Income Summary			
Index	YTM %	Total Return YTD (%)	Spread to benchmark (bps)
US Invt Grade (CS LUCI)	4.56	20.32	-366.70
UK Invt Grade (CS LEI)	4.40	9.01	-71.30
EUR Invt Grade (CS LEI)	3.17	11.76	-152.40
JPM Emg Mkt (EMBI)+	6.51	26.09	-373.10
CS High Yield Index	13.69	55.98	-1106.00

SOURCE: CREDIT SUISSE (DECEMBER 7, 2009)

Foreign Exchange			
Index	Spot Rate	End 2008	Change
GBP/USD	1.615	1.461	9.56%
EUR/USD	1.435	1.399	2.49%
GBP/EUR	1.125	1.044	7.22%
USD/JPY	93.10	90.56	-2.73%
GBP/JPY	150.30	132.35	-11.94%
CHF/USD	0.967	1.056	9.21%

SOURCE: FINANCIAL TIMES (DECEMBER 31, 2009)

Interest Rates %				
	CBR*	3M	12M	10 yr
US	0.2500	0.2506	0.9844	3.8400
UK	0.5000	0.6050	1.2475	4.0100
Euro Area (DE)	1.0000	0.6550	1.2175	3.4000
Japan	0.1000	0.2775	0.6938	1.2900

* Central Bank Rate

SOURCE: FINANCIAL TIMES (DECEMBER 31, 2009)

Alternative Investments					
Index	Price	Quarter (%)	1 yr (%)	5 yr (%)	10 yr (%)
Gold	1087.50	9.21	25.04	20.08	14.12
Oil (WTI)	79.36	13.32	102.27	12.97	11.77
Commodities*	767.66	7.08	18.32	5.28	10.77
S&P Global REITs	239.81	4.81	33.68	0.01	10.85

* Morningstar Long-Only Commodity Index

SOURCE: MORNINGSTAR (2010)

Economic Indicators				
	Unemploy-ment (%)	Current A/C Balance*	Budget Balance*	Industrial Production
US	10.00	-3.10	-11.90	-5.10
UK	7.90	-1.90	-14.50	-8.40
Euro Area	9.80	-0.90	-6.50	-11.10
Japan	5.20	2.70	-7.70	-3.90

*% of GDP 2009 estimate

SOURCE: ECONOMIST POLL (DECEMBER 30, 2009)

Volatility Index					
Index	Current	End 2008	YTD % Change	52 Week Hi	52 Week Low
VIX (S&P500)	21.68	40.00	-45.80	57.36	19.25
VDAX (DAX)	20.84	37.80	-44.87	47.52	20.43

SOURCE: FINANCIAL TIMES (DECEMBER 31,2009)

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Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

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The prices of real assets- precious metals tend to fluctuate widely and unpredictably, and have historically experienced periods of flat or declining prices. Prices are affected by global supply and demand, investors' expectations with respect to the rate of inflation, currency exchange rates, interest rates, investment and trading activities of hedge funds and commodity funds, and global or regional political, economic or financial events and situations.

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The initial interest rate on an inflation-linked security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in CPI. However, there can be no assurance that these increases in CPI will occur.

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