
Letter From The Portfolio Manager

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Potential Surprises for 2010



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Key Points

- *Our “surprises” consist of market views that we believe many, if not most, investors do not support.*
- *Reviewing our surprise list from last year, we did well.*
- *As for our surprises this year, our list includes our expectation that stocks will beat bonds again, that we will likely see an uptick in M&A activity, and that the U.S. dollar will do well.*

Each year, when we write our market outlook for the coming year, we like to present our views which, we believe, are not shared by most market participants. Our “surprises” aren’t heroic, low-probability long-shots meant to provoke, but instead are views that genuinely capture our outlook as well as why they may differ from consensus.

The twist to this year’s outlook is that this report highlights the individual and collective thinking of our research analysts; it is a team effort. Then again, our commentary essentially always is. Quality investment firms are rarely about a single individual. Instead, they have experienced teams that fulfill an investment philosophy and execute a disciplined process. As the differing views are introduced below, each analyst covering that particular market space will be highlighted with a byline.

Before we introduce our potential surprises for 2010, let’s first review our predictions on potential surprises from the previous year.

Review of Potential Surprises for 2009

1. Earnings Growth Will Be Better Than Expected

A year ago, analysts estimated that reported earnings growth for the S&P 500 in 2009 would be about \$42, which would represent a negative growth rate from 2008 of approximately -12%. That history almost seems quaint now as only a few months later actual earnings for the fourth quarter of 2008 were reported significantly below the December 2008 expectations. As a result, the outlook for earnings for the remainder of 2009 continued to plummet early in the year, with estimated reported earnings dropping to under \$35 by the end of March and to below \$28 by the end of May.

A year ago we thought that actual earnings could be better than expected for multiple reasons, including the impact of massive stimulus coming into the market, the tendency for consensus expectations to miss economic inflection points, and the sharp rebounds that typically follow earnings troughs.

As of this writing, and working with fourth quarter earnings estimates through the middle of December, reported earnings growth for 2009 is now expected to be almost \$50. This is nearly

20% higher than what the expectations were a year ago, never mind almost 200% above the expectations from late last spring. It looks like we hit this one on the mark.

2. The Global Stock Markets Will Have Above-Average Returns

Between 1900 and 2008, the world stock market outperformed government bills by 4.2% a year. In the United States, over the same time frame, stocks beat bills by 5.0% a year.

We thought that stocks could do much better for multiple reasons, including low interest rates, lots of cash on the sidelines, extreme bearish sentiment, massive liquidity injections, and because the market was extremely oversold. Nonetheless, we were early on that call, as the market continued to drop until it reached its low on the year in early March.

By year's end though, the All Country World Index was up 35% and the U.S. market, as defined by the Russell 3000 Index, was up 28%. Meanwhile, Treasury bills and other cash proxies essentially produced returns closer to 0% than 1%. In sum, the global stock markets did indeed produce above-average returns.

3. Larger Companies Will Do Better Than Smaller Companies

We thought the large capitalization stocks could outperform small capitalization stocks for a handful of good reasons, though the leading reason was relative valuations: large caps looked very cheap relative to small caps.

Were we right? Not quite. Perhaps the most common way of measuring the large vs. small performance question is to compare the S&P 500 (a common proxy for large caps) versus the Russell 2000 (a pure benchmark for small caps). Though large cap companies did hold the performance advantage heading into the last several weeks of the year, small cap companies had a terrific run in December and nosed out the S&P 500 in the end. For the year, the Russell 2000 returned 27% and the S&P returned 26%.

By the way, we still think large caps will outperform moving forward. By year's end, the relative valuation argument in favor of large caps was even stronger than it was twelve months ago.

4. Lower Quality Bonds Will Outperform Higher Quality Bonds

A year ago, investors were gobbling up nominal Treasury bonds and selling high yield bonds as fast they could. As a result, high yield bond spreads skyrocketed higher suggesting a once in a generation buying opportunity for these bonds. Though we expected default rates would go up, we felt that the yield spread provided a fair margin of safety.

As for the results, the Barclays Capital High Yield Index returned 58% for 2009 while the Barclays Capital U.S. Long Government Bond Index **lost** 12% and the Barclays Capital Aggregate only returned 6%. Lower quality bonds didn't just outperform higher quality bonds, they did so by a significant margin.

5. Inflation Expectations May Reappear

A year ago, the markets were pricing in a severe economic contraction, including a strong expectation of outright deflation. This was expressed in historically low Treasury bond yields, as well as the extremely low “break-even inflation rates” (the yield difference between nominal Treasury bonds and inflation-linked Treasury bonds). We felt that inflation expectations would likely reappear for several reasons, including our expectation that the strong liquidity/quality preference by investors would dissipate, as well as because of the massive stimulus from fiscal and monetary policy. In short, we felt that Treasury yields and break-even rates would move higher in 2009.

While it can be argued that inflation was not out of control by year-end, nor that inflation is necessarily likely to explode higher in 2010 (more on that later), we did see a significant uptick in yields and market expectations. Ten-year Treasuries, for instance, moved from a 2008 ending level of 2.2% and ended 2009 at 3.8%. Long Treasuries meanwhile, moved from 2.7% to 4.6%. And, ten year break-even inflation rates (which we think is generally a better indicator of inflation prospects than most other forecasting methods) went from 0.1% to 2.4%. In sum, Treasury yields and break-even rates did move higher in 2009.

Potential Surprises for 2010

1. The Stock Market Will Perform Better Than Fixed Income

Despite the strong stock market returns in 2009, and with money starting to flow heavily out of money market funds, one of the more remarkable statistics from 2009 (through November) was that equity mutual funds still had net redemptions. To re-state, more money flowed out of equity funds than into them. However, despite interest rates being extremely low and thus suggesting low prospective returns, fixed income funds had heavy inflows. Given this flows data, it appears that most investors are much more comfortable with the return prospects of bonds than with the stock market.

While the stock market is no longer cheap in our opinion (though not necessarily expensive either), and is coming off one of its best calendar years in its history, we still think that the stock market looks more attractive than fixed income in terms of total return potential for the foreseeable future. This is a function of two factors.

First, the fixed income markets appear to be fairly pricey now. The over-all level of interest rates is still relatively low in nominal terms, and especially so in real (i.e., nominal yields minus inflation expectations) terms. And it's not just Treasury bonds that look expensive. Corporate bonds, thanks to their spectacular year, appear to be less attractive than they were twelve months ago. Cash meanwhile, still essentially yields 0%.

Second, we think that the stock market still has the potential to extend the gains from 2009. One factor that we think is supportive of the stock market is that we still expect corporate earnings to surprise to the upside. Even though GDP growth historically tends to be over 7% in the twelve months following economic troughs after severe contractions, the current consensus view for GDP growth in 2010 is still around 2.6%. Even if one goes with the assumption that “this time is different” and we will get a below-average rebound, it is our opinion that current expectations still seem too low and are likely baked into current stock market prices. Even corporate earnings expectations for 2010 and 2011 are well off 2007 peaks; expected reported earnings for 2010

are still approximately 35% off their 2007 peaks and expected reported earnings growth for 2011 is still more than 20% off the prior peaks.

The market is always reacting to expectations and changes in those expectations. Given that estimates for economic and corporate earnings growth continue to *slowly* improve, but most likely not fast enough given that history tends to reveal quick rebounds, we believe that this remains a powerful tailwind for the stock market.

In addition, as for that aforementioned cash that is earning a bit more than nothing, we think that as expectations and confidence (and perhaps stock market prices) improve, a lot of that cash sitting there “until the storm passes” might start working its way back into stocks – and not bonds.

2. Dividend Paying Stocks Will Outperform

David Lebovitz, Research Analyst

Many investors do not seem particularly fond of dividend paying stocks. We think that view will eventually change.

Despite the strong gains last year, dividend-paying stocks were clearly left behind. For example, as of December 18, 2009, dividend paying stocks in the S&P 500 returned an average of 33%, while members of the index that do not pay dividends doubled that return with an average of 66%. However, this relative performance is not a total surprise as this trend of underperformance manifested itself prior to 2009, with dividend paying stocks failing to perform as well as their non-paying counterparts in recent years.

We believe that dividend paying stocks may start to perform relatively well moving forward and should not be ignored for a number of reasons. First, we believe that higher quality stocks are cheap relative to the rest of the market. There are various attributes that higher quality companies generally share, including more stable earnings, lower debt levels, and higher dividend yields. Dividends are a signal of a company’s financial health; a company that is paying dividends is likely to be financially sound.

Second, we believe that dividend yields have a couple of attributes that long-term investors will find increasingly attractive. One, more and more investors are increasingly drawn to the yield itself, especially with cash and fixed income yields so low. Another feature is that stocks with dividends tend to be more stable in terms of price volatility. As many investors start to warm back up to the stock market, the fact that dividends may offer some downside protection during turbulent markets may be appealing.

There are a multitude of studies that support investing in dividend paying stocks. Many studies have found that for stocks around the world, dividends are the most important contributor to total return in the long run, and that they deliver this greater return for significantly less risk. Thus, given where dividend paying stocks currently stand, as well as the research that supports their out-performance in the long-run, we believe that dividend paying stocks should not be ignored in 2010.

3. The U.S. Dollar Will Be Stronger

Greg Kelly, Research Analyst

Perhaps one of the more popular views in the market this past year was that the U.S. dollar would significantly weaken. And weaken it did, as the U.S. Dollar Index peaked in early March and moved significantly lower until the dollar started to rally hard late in the year. At year-end, the U.S. Dollar Index was down approximately 4%.

Losses for the year were driven by a couple of key factors. First, the loudest bearish voices remain concerned by an accommodative Fed and high debt levels. Second, dollar losses were propelled by unwinding of the fear trade that drove investors to the dollar during the second half of 2008 and early 2009.

Where to from here? Short-term, the overwhelmingly near-unanimous bearish view that absolutely dominated for most of the year appears to be finally lightening up. Price action in the closing weeks of the year also suggests a change in the tides. Given the reputation for currency markets to trend on emotional waves, this may be an important turning point.

More important though, the dollar appears to be fundamentally cheap. Using the Purchasing Power Parity (PPP) theorem, which states “that exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at that rate of exchange are equivalent,” the dollar is cheap. At the end of November, for instance, the dollar appeared to be over 20% undervalued relative to the euro, as well as being undervalued relative to five of the six currencies that comprise the dollar index. We recognize that using PPP for currency valuations is controversial, especially for short-term forecasting. However, it seems to be a good starting point for assessing value, particularly when PPP suggests significant undervaluation.

So, what about the concern regarding debt levels? We do believe that a high level of debt is a legitimate concern, but we also believe that the dollar doesn’t have to go to complete hell in the near future either. It is important to remember that currency rates are the ratio of one currency valued against the worth of another currency and that other countries have high debt levels as well. While this argument may sound like a child saying “but all the other kids are doing it,” we are not making the point that high debt levels are good, but rather that the dollar is not likely to lose its status as reserve currency once one reviews the debt/GDP ratios among developed economies.

All else being equal, a stronger dollar would provide a tailwind for domestic securities to outperform international securities.

4. M&A Activity Will Pick Up

Ben King, Senior Research Analyst

The volume of mergers and acquisitions is at its lowest levels since 2002. At the beginning of December, there had not been a leveraged buyout in 2009 and we have not seen a private acquirer of a public company since March. At first glance, the current environment does not feel like the time to attempt to make money from mergers or merger arbitrage. Nonetheless, we

believe that the recent economic crisis has introduced a number of positive factors for this investment strategy.

During the crisis, when it became more difficult for companies to borrow money, there was great concern over how some of them would survive. In Washington, the response was to aggressively lower interest rates. In corporate America, companies began hoarding cash. The final result is that we now find many cash-rich companies earning very little on their savings and no levered competition for acquisitions.

As the economy returns to some sense of normalcy, the sensible outcome is that investors will not be content to have cash on the books of their companies earning virtually nothing. Among the various options (including raising dividend yields), one likely outlet for this cash is to engage in acquisitions. This has already begun to occur.

With the lessons of 2008 and 2009 fresh in the minds of every company executive and investor, it is fair to assume that the buying will be more disciplined than it was in the past. The acquisitions will tend to be strategic (related to the acquirer's pre-existing business), rather than the speculative buying that characterized the boom years, and acquisition prices will likely be at more reasonable valuations than they had been previously.

Based on this scenario, expect to see:

1. Smaller price spreads than we might have seen in the past.
2. Shorter deal durations than were common in the past.
3. Lower risk of deal failure.
4. Low (with some possibility of rising) interest rates.

Generally, these are positive signs for merger arbitrageurs. This does not mean that the asset class will necessarily provide extraordinary returns in 2010, but it does give some confidence that experienced merger arbitrage managers should be a good place to seek fixed-income-like returns over the coming year.

5. Interest Rates Will Not Skyrocket Higher

Jeff DeMaso, Senior Research Analyst / Portfolio Assistant

One of the most interesting contradictions in the market is how remarkable the cash flows have been into fixed income securities, yet to many investors, there seems to be a strong case for sharply rising interest rates.

The case for skyrocketing rates seems to be all over the media, with some pundits touting that betting on rising rates is the single best trade for 2010. With the US Government running a massive deficit, the Treasury is issuing record amounts of debt and the Federal Reserve's balance sheet is ballooning; add in near zero short-term rates and long-term rates at multi-decade lows, where could interest rates go but up – if not sharply higher? The main thrust to the argument for higher rates is that they will be necessary to combat higher inflation fueled by the government spending and the Fed's printing of money.

While we expect interest rates to trend higher over the long-term, they don't necessarily have to skyrocket higher in 2010. There are a number of factors weighing against inflation. First, the

deleveraging and unwinding of credit process we are currently working through is inherently disinflationary. Additionally, with unemployment in double digits there is no wage pressure – a lead factor for inflation. Finally, there is massive excess capacity in the economy; with capacity utilization at such low levels, there is a lot of slack to be absorbed before inflation is likely to take hold.

Another factor that could keep rates from skyrocketing higher is the Fed's commitment to keep rates low. In their November statement, where they left the federal funds rate unchanged at 0.00% - 0.25%, they outlined three factors that were influential in their decision:

1. Low rates of resource utilization,
2. Subdued inflation trends, and
3. Stable inflation expectations.

At this time only the final factor – stable inflation expectations – could be of concern as the ten year break-even inflation (the difference between nominal 10-year Treasury yield and 10-year Treasury Inflation Protected Security yields) has been climbing and could indicate rising inflation expectations. Although at a spread of just over 2%, this is still around the long-term averages. Were the Fed to raise short-term rates, given the steepness of the yield curve, there is arguably room for short rates to rise without long-rates rising to the same extent.

Finally we can address two arguments which could be filed under the “conspiracy theory” heading. One is in favor of higher rates and one is against higher rates. The first is that foreign governments will stop buying US Treasuries and/or dump their holdings of dollar denominated assets en masse. While we expect foreign governments to look to diversify their holdings in the future it will likely be a long-term process. As seen in the crisis of 2008, US Dollars are still the destination of “flight to safety” money. Additionally, were governments to dump their dollar denominated assets, it would be detrimental to their holdings as well. The second “conspiracy theory” is that the Treasury has announced its intention to extend the maturity of US debt. This would provide significant political pressure to keep long-term rates low.

In sum, do we think rates trend higher over time? Yes, but they don't have to skyrocket higher tomorrow, next month, or even over the next year. Rates can stay lower longer than anyone might initially expect – see Japan. Also, remember that while rising rates are a headwind for fixed income markets, it is not impossible to still generate positive returns in a rising rate environment. In 2009, for instance, longer maturity Treasury bond interest rates rose nearly 2%, but many credit markets posted historically strong positive returns.

The Greatest Investment

Recently, I exchanged emails with someone I consider to be a very wise man and an accomplished businessperson. Let's call him a mentor of a mentor. In short, we were talking about investments and this was his hot pick for the new year:

“The perfect investment is...in oneself.

...Unlike material possessions, personal capital provides real, continuing return on investment, has intrinsic value, has low risk (low volatility of returns), can not be taken

from you, and provides tangible daily pleasure.

True personal capital is the greatest of all possessions, even to the end. As Victor Frankl says in 'Man's Search for Meaning': "...everything can be taken from a man but one thing: the last of the human freedoms—to choose one's attitude in any given set of circumstances, to choose one's own way."

Sounds like classic wisdom to me.

We all wish you a happy and prosperous New Year.

Sincerely,



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