April 2010

Monthly Investment Commentary

Following a strong March, all domestic equity asset classes are now well into positive territory year-to-date. The large-cap Vanguard 500 Index was up 5.4% for the quarter, while the iShares Russell Midcap benchmark gained 8.6% and the small-cap iShares Russell 2000 gained 8.8% for the first three months. Foreign stocks also posted strong gains in March and are now in the black for the year so far, with the Vanguard Total International Stock Index and the Vanguard Emerging Market Stock Index up 6.7% and 8.2% for the month, and 1.5% and 2.5% for the quarter, respectively.

Turning to fixed income, the domestic intermediate-term, investment-grade Vanguard Total Bond Market Index gave up a bit of ground (-0.1%) in March, though posted a positive 1.7% return year-to-date. Developed foreign bonds (as represented by the Citigroup World Government Bond Index) slid 1.7% in March and are down 1.3% for the year so far. Emerging-markets bonds gained an impressive 4% for the month (as measured by the JPMorgan GBI-EM Global Diversified Index), ending the quarter with a 5.4% return. High-yield bonds posted a 3.1% gain in the month, ending the quarter up 4.8%.

Our models all beat their benchmarks in the first quarter, and remain well ahead over the trailing 12 months. We talk more about our current views and future performance expectations in the commentary below.

The Big Picture, the Investment Landscape, and Our Portfolio Strategy

Making decisions is easy; making good decisions is the hard part. Making good investment decisions is especially difficult because it requires blending information, analysis, experience, judgment, and client needs on a playing field where the game never stops, the rules can change without warning, and almost nothing can be known with certainty. Some environments are more difficult than others because the consequences of being wrong are potentially higher, and/or because the range of possible outcomes is wider. This is the kind of environment we believe we are in now, and it influences the way we approach our research and, in turn, the investment decisions we make.

We are expending a huge amount of research effort to make sure we thoroughly understand the overall (macro) environment we are in and the various ways it could play out, and to make the best investment decisions we can based on that understanding. More so than in past periods, the investment climate in the years ahead will be highly influenced by how certain macro trends unfold, particularly the massive amount of debt within the global system.

We realize that not all of our readers want the same level of detail, and we have tried to take that into account in how we present our commentary this month. Our readers' confidence in our decisions is a function of the quality of our thinking and analysis, and for this reason we have always been careful to provide a lot of the reasoning and factual support that underlies our decisions. But given the scope of the analysis we feel compelled to do in this highly challenging environment, there is even more detail than we usually provide. To make this more accessible, we have divided our commentary into separate sections.

The first section goes through the macro situation in detail and includes our take on a series of questions many investors are asking. These big-picture issues are likely to determine how the economic environment unfolds in the years ahead. Our 30,000-foot view of these big issues forms the basis for our assessment of the investment landscape, which is provided in the second section. Both of these sections are quite long, so we have provided short summaries at the beginning of each and we include highlights of key points throughout.

Section three covers the practical conclusions of our work: how the macro environment and our assessment of investment valuation feeds back into a portfolio strategy, how Litman/Gregory's investment capabilities are positioned as we enter a new decade, and how we seek to make good use of those capabilities on behalf of our clients.

Looking Down From 30,000 Feet, the Landscape is Dominated by Mountains of Debt

"I'm living so far beyond my income that we may almost be said to be living apart."

—E. E. Cummings

SUMMARY We've seen massive growth in debt throughout society, reaching binge levels in the last decade. This debt growth fueled a lot of spending, but reducing debt means the money has to come from somewhere, and much will come from reduced spending. This suggests a sluggish economy, possibly for many years to come.

Meanwhile, government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage—including the possibility that shifting gears to cut budget deficits too early could throw the economy into a significant and ugly decline.

The recent economic strength stems mostly from this stimulus spending and smaller inventory drawdowns, both of which can't be sustained. A key factor in the economy is jobs, and data suggests the job market remains poor and there is little basis to think this will change quickly or dramatically.

Other big problems include huge amounts of commercial real estate debt coming due, continued strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.

A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. The powerful rally in "risk" assets over the past year is certainly comforting. And we take some satisfaction in the returns we've achieved for our clients (and ourselves) since that time. However, we remain quite concerned, and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed. Though the worst case of a great depression has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness. Many sectors of the global economy still must reduce debt (or at least, debt growth) and spending levels, including: households in the United States and a number of developed countries, state and municipal governments, most developed country governments as well as some lesser developed countries (e.g., Greece), and the residential and commercial real estate sectors.

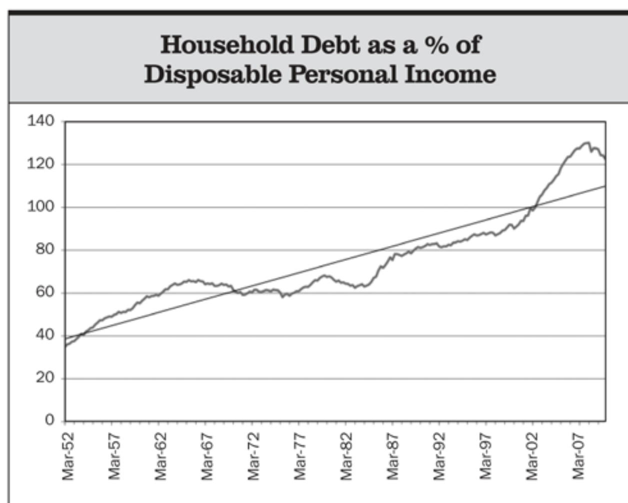
A Simple Reality

There is a simple reality to this process of deleveraging. If debt is being reduced instead of expanded, the money has to come from somewhere and it is spending that will take most of the hit. In addition, some debt will be reduced via defaults which harm lenders—there is no painless way for an economy to de-lever. This process is likely to take several years, during which economic growth will be subpar. During this period financial fault lines are likely to remain stressed, leaving us cognizant of heightened risk. Our view is a function of:

- our own study and analysis of data
- a review of various historical analysis of other banking crises, and debt and asset bubbles that include periods like the Great Depression and post-1980 Japan as well as many other episodes in smaller economies
- ongoing review of a wide range of analysis and opinions from well-known big-picture thinkers, academics, economists, and others in our industry
- discussions with various experts we respect

By now the story of how we got into this mess is generally understood—even by much of the public. The generation that grew up during the 1930s had learned to avoid debt. Debt relative to income was less than 40% in 1950. But over time new generations of adults increasingly viewed the economic collapse of the 1930s as something that would not be repeated and they gradually became more comfortable with borrowing. By 2008 household debt relative to annual income had more than tripled from the 1950 level, hitting 130%. During this period borrowing supported a portion of consumer spending and economic growth. There was a particularly steep acceleration in indebtedness in the 2000s as many went hog wild, borrowing more and more against their houses and credit cards relative to their earning power. They believed their homes would always increase in value and that they could always keep deferring their debt by rolling it over into the future (through refinancing). These beliefs were not well founded. But it is not surprising that people became so willing to pile on more and more debt to support spending. For most adults it had become easier to borrow in each successive economic cycle thanks to financial innovation which ultimately resulted in inadequate lending standards and a lack of accountability on the part of lenders. So more borrowing in order to pay off prior debt and support new spending became the norm. This created a false sense of security with respect to the ability to always borrow more, and also, complacency as to how this debt would be paid back. But now the long-term cycle of debt expansion is over, at least for the household sector. It was clear that the game would end sometime, the question was when.

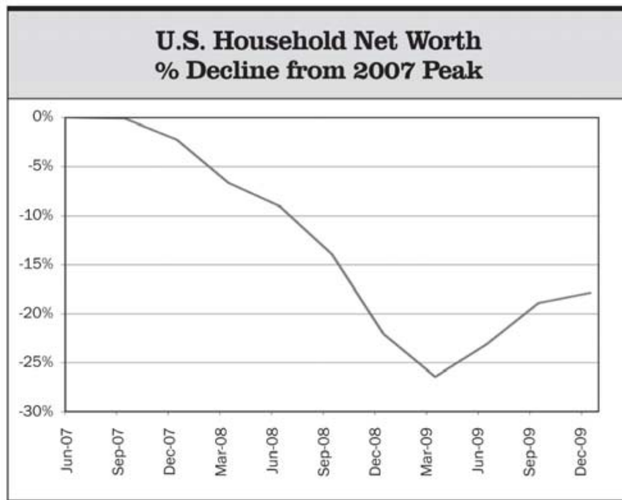
Over the past 18 months, as consumer spending for goods and services declined significantly, governments kept the global economy from falling into an abyss. But the underlying problems of far too much debt and a needed cutback in spending remain. The deleveraging has started for households and the financial sector, but it has a long way to go even though debt has declined at the fastest pace since 1942. The magnitude of public debt is now becoming a concern as governments' spending in support of the economy at a time when tax receipts have shrunk has led to surging deficits.



Debt is coming down, but is historically very high relative to income.
Source: Federal Reserve.

To grasp why we believe the case for a weak recovery is compelling, it is helpful to remember that economies are driven by demand for goods and services. Consumption drives about 70% of U.S. GDP—clearly it is very significant to our economy. Consumption is in turn primarily driven by four factors and the status of each is not encouraging:

1. The income of potential consumers: Excluding government transfers, real personal income has declined over the past two years, primarily driven by a high level of unemployment.
2. The wealth of potential consumers: With the massive loss of home equity and the stock market still down 25% from its 2007 peak, people feel poorer because they are poorer. Overall household net worth is down close to 20%.



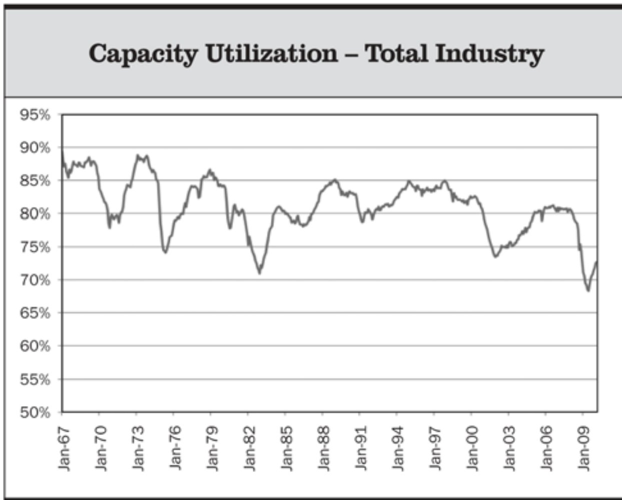
Americans' net worth has increased from a year ago but is still 18% below its 2007 peak. Source: Federal Reserve.

3. The borrowing ability of potential consumers: Borrowing is driven by asset levels (which are down), the capacity to take on more debt (which hit a wall), and the willingness of lenders to lend (lending standards have tightened).
4. Consumers' desire to spend (and to borrow to support spending): Aside from the ability to spend and borrow, there are hints of a new frugality that may result in some shift at the margin in consumers' willingness to spend on certain types of goods.

Think of all that debt as a form of borrowing against future consumption—now we must pay it back in the form of less spending. Before the decades-long spike in borrowing, the consumers' share of the economy was in the low 60% range for years. We don't know if it will go back to that level but the factors listed above are not likely to improve dramatically any time soon and that is why sluggish spending growth compared to past expansions seems quite likely.

This quick overview of the macro picture doesn't tell the whole story. Much uncertainty remains, so before getting into what this all means with respect to investment opportunities and our investment outlook, we share our thoughts with respect to some key questions our readers may be wondering about.

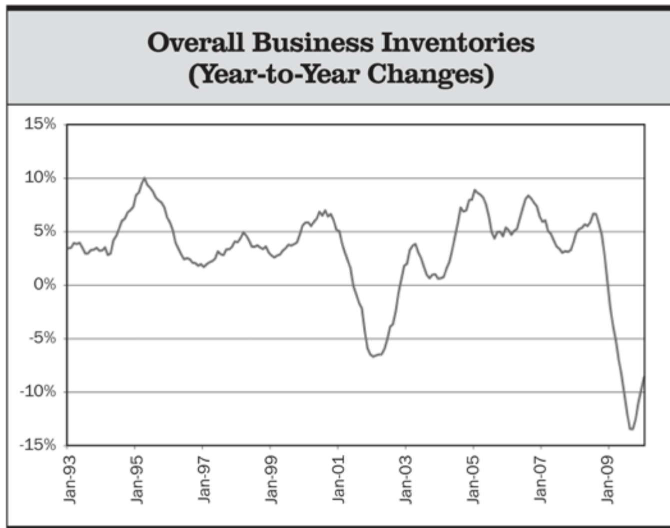
The economy had very strong growth in the fourth quarter—doesn't this suggest a strong recovery?
It is true that GDP growth was very strong in the fourth quarter, though the economy remains far below its prior peak according to most measures. Recent growth has two drivers: 1) massive government stimulus and 2) lower inventory drawdowns (companies are still drawing down inventories—selling more than they are producing so that inventories decline—but the drawdown has slowed). The problem is that both of these factors are temporary.



At only 73% of capacity, there is lots of excess slack which will help restrain inflation for now. Source: Federal Reserve.

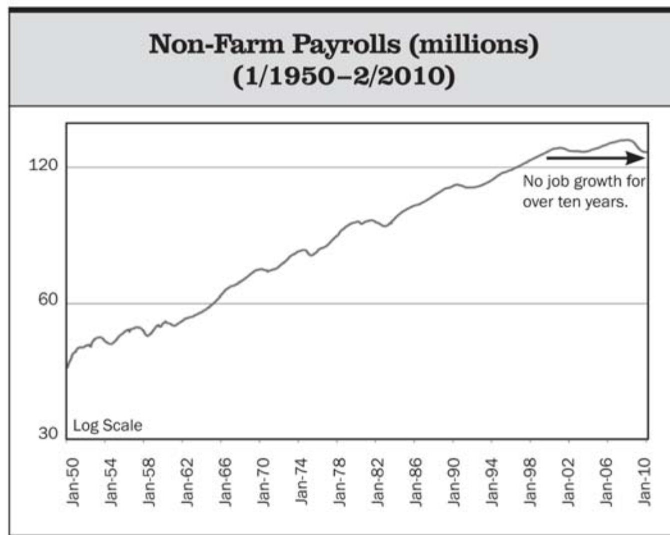
There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is quite possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will pass as the year progresses. Other sectors of the economy are strengthening—manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is on fragile footing. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again. In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests to us that a sluggish recovery is the most likely outcome over the next couple of years and that there is still risk of a return to recession if government policies are not skillfully managed.

Starting to grow, but still far below the peak and back to 1999 levels. Source: Federal Reserve.



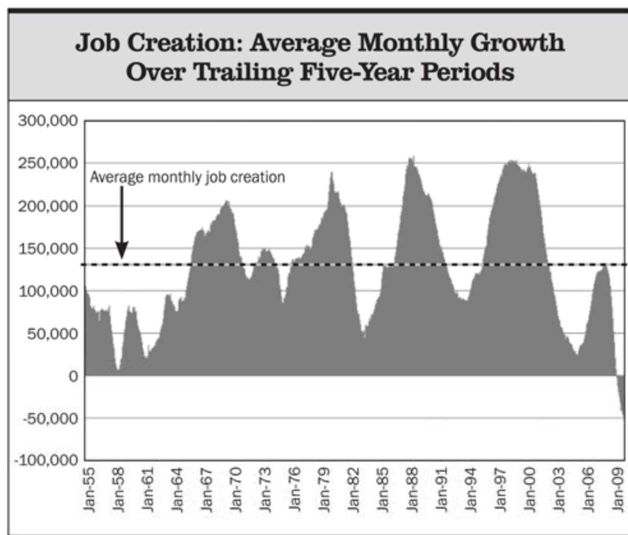
The inventory drawdown is slowing. Source: U.S. Census Bureau.

Is there a key to a strong and sustainable economic rebound?
There are several important variables, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. Some of the recent improvement is a function of discouraged job seekers discontinuing their job search, which makes unemployment numbers look better than they would otherwise. But while the labor market remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation. The labor market will be aided the next few months as more than one million temporary census takers are hired.



Source: Bureau of Labor Statistics.

The Congressional Budget Office (CBO) projects that the unemployment rate will be back down to 6% by 2013 and 5% by 2014. However, there are many assumptions in that projection, including the economic growth rate. They project growth will average about 4.5% from 2012 through 2014. This may be an aggressive assumption. According to Ned Davis Research, Inc. (NDR) the CBO forecast implies growth of 300,000 jobs per month in 2012 and 2013. That is certainly possible but we have not come close to that growth rate over any two-year period since the mid-1990s. It is also interesting that the President's Office of Management and Budget (OMB) more cautiously predicts that unemployment will still exceed 9% in 2011 and be 6.5% in 2014—implying, according to NDR, monthly job creation of 210,000. According to NDR, if job growth averages 150,000 per month over the next 10 years, unemployment will never fall below 6% and won't fall below 7% until 2018. Using the last 20 years as a frame of reference, average monthly job growth over that time, excluding the more than eight million job losses during this recession, was only 137,000.



According to Ned Davis, if job growth averages 150,000 a month over 10 years, unemployment won't fall below 6% until 2019, or below 7% until 2018. It would break below 10% in 2013. Average monthly job growth since 1950 has been 120,000. The last 20 years, excluding the impact of the recession, job growth has averaged 137,000 per month. Source: Bureau of Labor Statistics.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests to us that even with a strong temporary snapback, we shouldn't be optimistic about a return to a strong labor market for several years.

What about real estate and the financial sector—have they turned the corner?
Residential real estate (housing) is still a wild card, and commercial real estate is still in trouble. This means the financial sector will continue to face significant risks from these areas.

With respect to housing, while prices have bounced off the bottom it is not clear that we have seen the ultimate bottom. Despite massive federal support that has lowered mortgage rates, attempted to forestall foreclosures, subsidized new purchases with tax credits, and much improved affordability, the housing market outlook remains clouded. This is because the volume of potential foreclosures remains enormous. A quarter of all homeowners with mortgages are underwater (debt greater than their home value), and many of those loans are adjustable rate mortgages that will face higher payments over the next couple of years. Throw in very high unemployment and it's not a pretty picture. We've seen estimates of as many as three million coming foreclosures (there have been over five million foreclosures in the last two years according to RealtyTrac). Foreclosures add to the inventory of unsold homes, which is a negative for prices. Moreover, after a sharp increase, the number of home sales last fall slumped sharply in the last two months. The impact of upcoming foreclosures will depend on the economy, the number of homeowners willing to give up their homes, and the effectiveness of current and future government assistance. If it is very bad, it will create more stress for banks because they still have loan loss exposure (particularly in the second mortgage and home equity market). Despite good affordability, the huge uncertainty about the magnitude of foreclosures makes it hard for anyone to confidently know if prices have bottomed, though most experts think it will be this year. And given the realities, even if prices have bottomed, a strong rebound for housing is unlikely for the foreseeable future given the supply glut and other stresses.

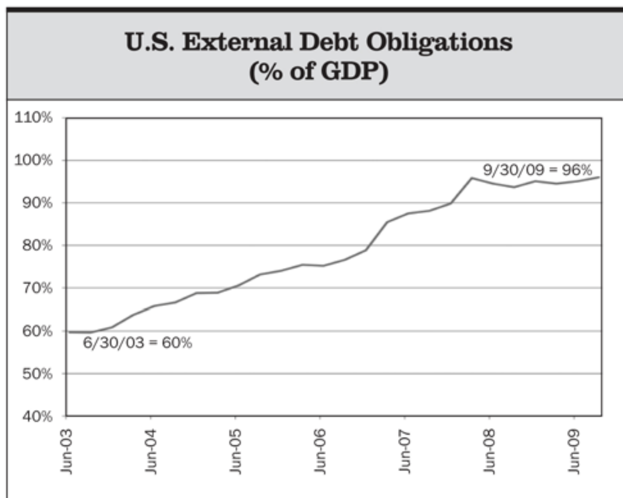
Though the collapse in commercial real estate prices may be near an end, commercial real estate loan defaults look like a coming train wreck that will be another problem for banks and the overall economy. Between 2010 and 2014 it is estimated that about $1.4 trillion in commercial real estate loans will come due. It is estimated that for almost half of these loans, the borrower owes more than the property is worth. Many of these properties may receive loan extensions but there is little doubt that there will be hundreds of billions of foreclosures

that will result in many more bank failures (mostly smaller/regional banks) which will then feed back into the overall economy. The extent of the damage will be impacted by how strong the recovery is in the 2011 to 2014 time period when the majority of loans come due.

How long can developed economies continue to run large government deficits?
Current deficit spending isn't sustainable and will have to be reduced at some point. This is a significant long-term risk for the United States, United Kingdom, Japan, and much of Europe. However, in the United States we expect a debate to rage for some time regarding when to aggressively attack the deficit. It's a difficult question with Nobel Prize winners on both sides of the debate.

Proponents of more government stimulus recognize that government debt must be reined in. But they also believe that it will take years for the private sector to deleverage and until that is complete the government has to step in to make up for inadequate private sector spending. Without high levels of government spending to fill the void, some believe depression is possible or at least a long period of extremely slow growth and high unemployment. The United States in 1937 and Japan in 1997 are the two most common examples of government spending cuts that were too aggressive too soon and were followed by a second economic collapse. In this scenario, efforts to shrink the government deficit backfired because an economic collapse results in lower government revenues and higher social spending.

Others believe that the private sector will gain traction and that if we wait too long to show more spending discipline, we risk our ability to finance our debt at an affordable cost. One worry is that because foreigners (mostly governments) own 50% of our public debt and funded all the debt issued in the last year, they may begin to expect that we will effectively default by inflating our way into paying them back with cheaper dollars (dollar depreciation). This would lead to a higher risk profile for U.S. debt and potentially, punishingly, high interest rates to provide the return necessary to attract the investment we need.



External debt is debt owed by the U.S. Government and the private sector to foreigners (including governments). It increased enormously between 2003 and 2008. Source: U.S. Treasury.

At this time, the one point we can confidently make is that unless we eventually rein in deficits, rising government debt levels coupled with demographically driven soaring health care costs will result in a public debt crisis. We have some time (probably several years) to begin to make changes to avoid a true crisis, but it is hard to confidently know when we will need to start showing some fiscal credibility to avoid a market reaction. It seems clear that both higher taxes and spending reductions will be needed.

Finding the right balance in the short term will be difficult. It will be hard enough for policymakers to get the analysis right without politics involved. Throwing public opinion and politics into the mix makes it hard to be confident that there won't be some costly mistakes made along the way.

Could growth in the rest of the world counterbalance slow growth in the United States?

Overall, the picture is mixed. While the developed world is simply not healthy, there are large portions of the emerging world doing much better. Growth in the emerging world is a positive that we factor into our earnings work—giving U.S. companies some credit for some incremental profit growth from sales to emerging markets. Much of the emerging world is not saddled with high debt levels, and many countries should benefit from a rising middle class—a long-term positive but one that also helps support growth over the short run. Many of these countries remain highly competitive in a number of export industries while others have commodity-driven economies that benefit from the growth in the emerging world. Generally, this part of the world is not immune to the weakness in the developed world, but they are potentially more resilient.

Europe and Japan, however, are not healthy. Both have very large levels of public debt (Japan's is huge at almost 200% of GDP), both are threatened by deflation; and, both are experiencing even weaker recoveries than the United States. Structurally, Japan looks worse, though Europe faces serious economic challenges as it deals with the complications of its common currency without the benefit of a political union. In aggregate, it seems unlikely that there will be enough growth outside of the United States, and consequently a significant boost from U.S. exports to other countries, to materially counterbalance domestic headwinds.

Won't all the government spending and liquidity infusion into the economy result in high inflation?
We are more concerned about high inflation longer term than near term. Over the next year or two, the combination of low demand growth (as we go through the deleveraging process) and excess productive and labor capacity makes a powerful inflation spike unlikely. Manufacturing capacity remains extremely high relative to history, and, as discussed above, there is plenty of excess labor, which means a wage-price spiral (as we had in the 1970s) is highly unlikely. Longer term, as we move through the deleveraging period, we believe there is heightened risk of an inflation spike. This factors into our scenario thinking toward the end of our five-year forecasting period.

What is the most positive macro argument that can be made?
The most positive case is that the continuation of unprecedented government fiscal stimulus, as well as inventory restocking and continued low interest rates, trigger more improvement in consumer and business confidence than we expect. U.S. companies, many of which have relatively strong balance sheets, begin hiring and we get a virtuous circle. Spending bounces back stronger than we expect as households manage to kick the debt further down the road. We end up with a better-than-expected cycle and the government gradually begins to address the deficit.

So, there is a reasonably positive macro case that can be made, and we consider that in our scenario analysis. However, the need to deleverage, the job picture, the many stresses that remain in the global economy (real estate, state and local government, public deficits, politics, and policy risk), along with the historical evidence from past extreme financial crises, suggest that the odds are skewed towards a less favorable outcome.

Our Investment Outlook in This Time of Great Uncertainty

"Recognize reality even when you don't like it. Especially when you don't like it."

—Charlie Munger

SUMMARY Our scenario-driven analysis gives us a good feel for the range of possible outcomes. We think mid-single-digit returns or worse are more likely for stocks than higher returns over the next five years. Our outlook for developed market foreign equities is similar and for emerging-markets equities is slightly higher across all scenarios.

We believe risks are relatively high, but we can't predict timing. We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion.

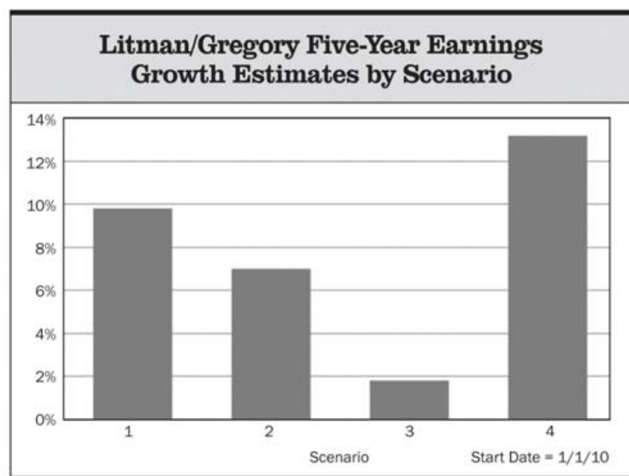
We never want to be complacent in our assumptions. We constantly test and challenge our own thinking, and look for new ways to analyze issues. One example is our work to approach the all-important question of what corporate earnings growth will be by analyzing historical sales and margin data. The results are slightly more favorable than our more conventional earnings growth analysis, which is based on a much longer history.

Many of the stock pickers we use report finding good opportunities, and there is some evidence that environments where overall stock returns are low but individual company returns vary widely are favorable for active managers. We believe we could see such an environment.

Among other asset classes, emerging-markets local-currency bonds remain a compelling opportunity, while high-yield's appeal has diminished and we could be close to unwinding those positions.

Our scenario analysis forces us to think about a variety of different macro outcomes over our five-year decision horizon. (We periodically reevaluate our scenario definitions and we are in the process of doing that now.) We then assess the return potential for each asset class in each macro scenario. Our valuation work is a major driver of the return analysis, though the macro factors are also important. It would not be shocking to find bargain valuations in some asset classes when the outlook is poor—often times risk is more than fully priced into financial assets in negative environments. Unfortunately, that is not the case today —generally speaking, return potential over the next five years is not compelling. However, that does not mean that returns couldn't be decent over the near term.

U.S. Stocks: There are lots of opinions about stock valuations. A good example was a March 9 article in the *Wall Street Journal* that contrasted the views of two well-known professors, Robert Shiller and Jeremy Siegel. Shiller thinks the stock market is overvalued and returns will probably be low over a period of years while Siegel believes the market is undervalued. Our approach differs from most because it is heavily driven by our scenario work that looks at the key variables (earnings and the P/E ratio) and assesses where they could be in five years. This allows us to factor in fundamentals and valuation. We also look at a number of other metrics as a reality check. These multiple models and outcomes give us a good sense for the range of valuation views. Overall, we find that even though we are assuming some snapback in earnings (this has already begun), in most scenarios our expected returns over five years fall below 5% annualized. In our most bullish outlook, stocks return just over 10%. Our results seem generally consistent with the many valuation measures that suggest stocks are somewhat overvalued.



Even in our "most likely" scenario 1, where we expect subpar growth, we forecast earnings growth to be nearly 10% per year as it snaps back from a very depressed level. This is based on GAAP earnings which we believe may not yet fully reflect financial sector losses.

One point we must reiterate is that our analysis is based on a five-year decision time horizon. The potential range of outcomes in any one year is much wider. For example, in 2010, though we think risk remains very high, we can easily imagine a strong return year for stocks. If the economy continues to gradually improve, interest rates stay low, policy errors are avoided, and companies benefit from some improvement in revenue while continuing to keep expenses low, investors may continue to grow more willing to increase their stock market exposure. Importantly, the low returns available in cash and fixed income create a powerful incentive for investors to take risk. This risk-taking could be sustained until a negative catalyst triggers heightened risk sensitivity. The catalyst could come at any time and could be economically related or policy related, such as a move to increase interest rates or aggressively unwind the fiscal stimulus.

We are determined not to be complacent about our assumptions. One of the key variables in assessing valuations is the level of corporate earnings growth. And though we have spent an enormous amount of time developing and refining our corporate earnings assumptions, we recently looked at earnings in a completely different way to see if we would come up with different results.

As we think about the equity markets, we also think about the potential for active managers to outperform, and we put some credence in the bottom-up views and analysis we hear from the stock pickers we respect (especially those who are not "perma-bulls"). A number of relatively conservative value-driven stock pickers we talk to (e.g., the teams at Longleaf, Artisan Value, Osterweis, and Fairholme, to name a few) are quite bullish about the individual stock picking opportunities right now. Others, such as Clyde McGregor (Oakmark Global) and the FPA team, are less so. However, they are still able to find good investments; and, since they run relatively concentrated portfolios they don't need to find a whole lot of them. We have also seen arguments from credible research firms regarding the potential for active managers to significantly outperform passive indexes in lackluster return environments, especially when there is relatively low correlation between individual stock returns. While we may be entering into such a period, and these arguments are encouraging, we have not seen supporting data that gives us a high level of confidence in them.

Foreign Stocks—Developed Markets: Our analysis suggests European equities will generate returns similar to U.S. equities over the next five years. Relative valuation metrics, such as the price-to-cash earnings discount relative to the U.S., are not far from the historical average. In terms of currencies, the euro seems fairly valued and the pound slightly cheap, based on the longer-term purchasing-power-parity (PPP) measure. We are not counting on currency being a tailwind to returns for a dollar-based investor, though history suggests currencies can be significantly out of synch with longer-term valuation measures such as PPP, so it's possible we could see some currency benefit. We believe Europe's earnings will grow at a rate similar to that of U.S. equities. Dividend yields are slightly higher in Europe, which is a minor positive, but, overall, we can't make a compelling case for or against European equities relative to the U.S. over the next five years.

On trailing valuation metrics, such as cash-flow yield, Japanese equities look slightly cheap relative to U.S. equities. Looking out five years, we believe Japanese corporate earnings are likely to grow at a slower rate than U.S. corporate earnings in part because Japan's economy will continue to suffer from anemic domestic consumption and experience sluggish growth. In addition, Japanese companies' profitability will likely be more volatile than their U.S. counterparts due to the former's greater dependence on exports. Relatively slow earnings growth and greater volatility or cyclicality in profitability warrants a valuation discount for Japanese stocks relative to U.S. stocks. So, currently, Japanese equities look fairly valued based on the relative valuation metrics we look at. That said, we are looking into factors that might lead Japanese earnings to grow at a higher rate than we currently expect. If we find we can make a convincing case for stronger earnings growth in Japan, their equities would be relatively more attractive. For example, Japan may benefit much more than other developed regions from China's growth. Also, Japan's private sector has largely shed its excessive leverage over the past two decades and if it starts borrowing and spending, earnings could grow at a much faster rate than we currently expect.

Foreign Stocks—Emerging Markets: Since May 2009, when we initiated a tactical position (which we since eliminated for our balanced models), emerging-markets equities have run up significantly. They

no longer look cheap in absolute terms and are not as attractive relative to U.S. and developed international equities. Our analysis of emerging-markets' expected returns continues to suggest slightly higher performance than U.S. equities in all scenarios. However, the expected return premium has shrunk (due to outperformance) and this diminishes their appeal from a portfolio management standpoint when considered relative to their downside risk. Therefore, at these valuation levels we consider the asset class suitable only for more aggressive or equity-focused investors, where shorter- and intermediate-term risk is less important.

In coming to this conclusion we haven't changed our underlying assumptions. In the most likely scenario we continue to assume that a strong recovery in consumption in some major emerging-market countries will offset some of the weakness in the developed world. In this setting we believe earnings can grow at around a 20% annual rate for the next few years and then revert to a long-term growth rate in the mid- to high-single digits. We continue to apply a multiple of 13x to earnings five years from now (this is a 15% discount to what we assume for the United States and reflects a risk premium for EM's expected higher volatility). Adding the dividend yield of about 2% gives us a return expectation of about 6%, annualized, five years out in the base case scenario. The five-year annualized return range looking at all scenarios goes from slightly negative up to 14%.

Emerging-Markets Local-Currency Bonds (ELB): This asset class offers a compelling tactical opportunity from a relative-return perspective versus the other major asset classes we track. We think it can generate mid- to high-single-digit returns in our most likely five-year scenarios—admittedly not spectacular returns but better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world. We recently increased our exposure to a full double weighting (10%) in our more risk-tolerant balanced models. This does not reflect any significant change in our outlook for the asset class, but is mostly the result of additional information collected and analysis that we have done recently. This solidified our strong, positive longer-term view for the PIMCO Emerging Local Bond fund/ELB asset class. The ELB position is funded largely out of a reduction in our equity exposure.

Given our large allocation to ELB, one short-term scenario that could hurt us involves emerging-markets currencies dropping sharply versus the dollar due to a "flight-to-safety," which could be triggered by fears of a double-dip global recession, sovereign credit default contagion, or any number of other surprises/shocks that lead to a huge increase in global risk aversion. In this environment, we assume ELB could decline in the low to mid teens over 12 months. However, we believe stocks would experience a larger loss, so we still expect the ELB position to add value at the overall portfolio level relative to the benchmark.

We Are Currently Using Flexible Fixed-Income Strategies

Eighteen months ago there were many table-pounding opportunities in the fixed-income market as everything outside of the government-backed market was in the bargain bin. Since that time every fixed-income sector except for government bonds has rung up big returns and that has been one of the key drivers of our strong performance. In total, our fixed-income funds added significant value last year versus the Barclays Aggregate Index. Now, however, the opportunities are not so compelling, though on a five-year basis the return potential is higher in non-government bonds. So for the most part we hold funds that have a high degree of flexibility. The focus of these funds varies—several will take some non-U.S. bond exposure if it is compelling, they will take some corporate bond and non-agency mortgage exposure, they may manage their duration (maturity strategy) more flexibly, or they may have expertise in a specific slice of the market (e.g., Osterweis Strategic Income in the short-term high-yield corporate market). Overall we believe our fixed-income exposure will be subject to materially less inflation/rising interest rate risk than the overall bond market and has higher return potential—possibly as much as one to two percentage points (except in a period of extended deflation or near-zero inflation). It also gives us some defensive ballast, though less in the double-dip recession scenario than the overall bond market. That is the compromise, but we make up for that in other ways at the portfolio level.

High-Yield Bonds: We did very intensive work on high-yield bonds in late 2008. Back then we viewed high-yield bonds as an asset class that had better potential than stocks in almost every scenario, and much less risk. Our modeling work and risk analysis left us highly confident in our conclusion and led us to make a big allocation to the asset class. It worked out much more quickly than we expected and we captured a huge return in 2009. High-yield has continued to do well in 2010, though the returns have been much more moderate.

As high-yield has rallied, we have gradually reduced our exposure including a reduction earlier this year. We no longer view the asset class as clearly superior to equities (both have low expected returns in most scenarios). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the huge increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over our five-year investment horizon has fallen below 5%, except in the optimistic scenario. And with pricing around par and the yield around 8%, risk is materially higher than it was when we were paying around 60% of par and yields were over 20%. We believe that risk has more likely than not been pushed out into the future because defaults are dropping dramatically and heavy refinancing has left most companies in good shape until new debt matures. But that could mean trouble in a couple of years. In 2012 through 2014 almost $1 trillion of bonds and leveraged loans will mature. We are likely to be completely out of the asset class long before then—perhaps quite soon.

Investment-Grade Bonds: Currently our investment in fixed income is driven by three factors:

- A defensive hedge against a deflationary economic shock
- A desire to capture as much absolute return as possible without undermining our defensive hedge too much
- Concern about inflation and rising interest rates at some point in the future—probably more towards the tail end of our five-year decision horizon

Bond yields are quite low, and bond math is straightforward. We can come up with a range of potential inflation and interest rate assumptions for each of our scenarios to determine what returns will be over five years for the overall bond market index. We start by looking at the asset class which includes a heavy slug of U.S. government-backed bonds (Treasury and agency securities), which are about 36% of the aggregate bond index. AAA securities are another 41% of the index. Because the yield on these securities is currently very low—well below 4%—the total return expectations are also low in all scenarios—generally between 2% and 3%. In every scenario we assume interest rates will be higher at the end of our decision horizon. The government-heavy bond index would perform best in a severe global recession/depression scenario because it would involve a flight to quality, but even then we'd only be looking at mid-single-digit returns. However, in that environment, returns could be much higher over short periods while riskier markets were melting down. We want to own some of these securities as a hedge against that type of scenario but we believe there are better opportunities in funds that look at a broader fixed-income universe and are presently less government-bond focused (see "We Are Currently Using Flexible Fixed-Income Strategies" sidebar).

For most of our clients with taxable accounts, as always, we own municipal bond funds (and use taxable bond funds when we believe they are likely to generate higher after-tax returns than munis). Despite the collapse in state and local government revenues we are confident that the funds we own are able to find plenty of bonds that have adequate revenues to service their debt. In many cases there are regulations in place that protect bond holders and give them a high level claim against the government's revenues.

The municipal market has performed well over the last year. Yields are lower than they were so potential returns have come down. Still, yields are still relatively attractive relative to taxable bonds—especially for longer-term municipals, the supply and demand picture in the municipal market looks good at least over the next year and the expectation of higher tax brackets suggests growing demand for tax-free income. There will probably be some defaults in the next few years that may occasionally spook municipal bond holders but we are not concerned about the long-term safety or returns in the funds we own. In short, yields remain high enough and market fundamentals good enough for municipal bonds to have a place in portfolios of high-tax-bracket investors.

Other Asset Classes: We continue to actively analyze the REIT market in great detail. However, since we are not close to making an investment in REITs (we believe they are overvalued) we're not going to get into a discussion here. We have also been recently active in assessing a number of alternative and absolute-return strategies. Some of these are fixed-income related and include active shorting. We've also recently completed due diligence on two arbitrage-oriented funds. We're in the process of considering the addition of one or more of these investments to our portfolios and will report further when we are ready.

The Value of Our Research is in the Decisions We Make With It

"Intelligent people make decisions based on opportunity costs—in other words, it's your alternatives that matter."

—Charlie Munger (citing Mankiw)

SUMMARY Investment decisions involve determining if you are being adequately compensated for risk. We think risk assets like stocks are not priced attractively enough to fully compensate investors for the risks we see. But periodic declines in the years ahead could give us opportunities to improve returns by adding risk when we expect to be paid better for taking it on—this requires patience.

The story that it may take years to complete the process of deleveraging is not uplifting. Skewing towards a positive view when the environment doesn't support it may feel better, but is not a path to generating better returns, so we are committed to working hard to understand the reality we live in and make decisions accordingly. That said, we think a volatile, challenging environment plays to our strengths. We have added significantly to our research capability in the past decade, and we think over the next decade this will help us ratchet down risk when it doesn't make sense to take it, and take advantage of opportunities when they are presented. If we can do this successfully then our own outlook is decidedly better than the mediocre outlook suggested by the big picture and current valuations.

The Portfolio View

At a portfolio level we think about the risk thresholds we target for each portfolio type, and we stress test the portfolios under severe bear-market assumptions with that in mind. As we think about portfolios today, there are several things we're cognizant of:

- the high range of returns going from our worst-case to base-case scenario
- the fact that in most of the scenarios we look at returns are not compelling
- the reality that expected returns generally are not exciting, and also that no single asset class is offering a tempting opportunity. Emerging-markets local-currency bonds are the most attractive asset class, but even there we're looking at the likelihood of single-digit returns
- our belief that systemic risks remain quite high
- the fact that there is an optimistic case to consider amongst all the negatives

This all nets out to a portfolio posture in which the risk we're willing to take is below the risk of the benchmark in all of our balanced portfolios. Since no asset class looks like a home run (or even an extra base hit) in the majority of scenarios, the odds of missing out by being conservative doesn't appear very high. Or, put another way, we don't believe we are likely to be paid much over the next few years to take risk, so below-average risk exposure is sensible.

The risk reduction comes from a substantial underweight to equities, and within the equity portfolio, an underweight to small-cap stocks. That underweight is partly offset by a more aggressive fixed-income portfolio. Also, a significant portion of the equity underweight is invested in emerging-markets bonds and high-yield bonds. We view these asset classes as less risky than equities, but materially more risky than investment-grade bonds.

We tend to think of our tactical weightings in 5% increments. At present, our balanced portfolios are a little more than two increments underweighted to equity risk (which we calculate by taking our actual equity fund underweighting and then partially adjusting it upward for our high-yield and emerging-markets bond positions).

Given our conservative positioning, we believe our portfolios will outperform their benchmarks in all of the scenarios we consider except for the most optimistic (in that one our Equity model could out-perform). However, in a very severe downturn, a possibility we don't dismiss, we believe we could slightly breach our 12-month risk thresholds.

In Pursuit of Truth

There continues to be great macro uncertainty, and we believe that will be the case for quite some time. Getting through the private sector deleveraging will take some years. When we are done with that, it is likely that our federal debt will be quite high, very possibly dangerously high. That, too, will take time to address.
We understand that the story we tell is not an uplifting one, but it is the only story we have to tell. There are a number of professionals in our industry who have a high degree of intellectual honesty. They try very hard to see things as they really are. They are willing to change their mind when presented with new information, and, they are not afraid to tell their clients the way it is, even if their story is not encouraging. We believe the majority of our industry tends to want to manage client expectations up—they want their clients to believe stocks are cheap, problems solvable, the outlook rosy—and perhaps they want to believe it themselves. We take pride in our commitment to belong to the first group—the truth seekers.

Most likely, if our analysis is right, we will experience a downturn at some point in the next few years (or sooner). That will be unpleasant, but when that happens we will have a new opportunity to get paid for taking risk—probably in the global stock market and the high-yield bond market. Over the next five years and longer, one or more cycles of volatility will present us with an opportunity to add value over and above what we could do in a more steady market environment. That is what happened over the last 10 years. (Each of our portfolio types added significant return over the performance of their passive index benchmarks.)

So as we embark on this new decade, despite a far-less-than-rosy outlook, we also allow ourselves some optimism for two reasons. First, we believe our investment philosophy and process is particularly well suited to an environment that could be volatile. We believe this because of 1) our willingness to cast a wide net as we consider traditional but also somewhat untraditional asset classes/investment opportunities (emerging-markets local-currency bonds, short-term high-yield bonds, etc.) and 2) because we are willing to position portfolios significantly differently from our benchmarks if our research clearly suggests that is the smart thing to do. We are not index huggers—afraid to act on conviction because we might look bad temporarily.

Second, Litman/Gregory has experienced significant growth over the past 10 years, and we have used that as an opportunity to reinvest in our business. We have a much deeper and more talented research team than we have ever had. We have models and processes for analyzing asset classes, investment opportunities, and scenarios that did not exist 10 or 20 years ago. We have more resources in terms of data and access to other thinkers we respect. And we have a deeper and wider network that we tap into regularly to discuss and share views about the markets, risks, and opportunities. In short, we believe our capabilities have grown significantly in the last 10 years and since our founding 23 years ago, and that will help us in our ongoing pursuit of investment truth.

—Litman/Gregory Research Team (4/1/10)