

The past eighteen months have witnessed a wide spectrum of the many facets of human emotion: euphoria, uncertainty, fear, despair, panic, uncertainty, hope. As we reflect upon our decisions this past year and our evolving strategy for the next several years, we are calibrating our outlook over different time frames – short-term (about twelve months), medium-term (about five years) and long-term (fifteen-plus years). Our flexibility as we navigate the rapid changes taking place over these periods have served us well in the past and will be the key to preserving capital for our clients in the years to come.

Our fourth quarter 2008 commentary was fraught with concern about the side effects of massive government intervention worldwide. We stated, *“The risk now is that governments in their desire to do something — anything — in contrast with laissez faire policies of the early 1930s, will likely allocate resources to the wrong areas and create enormous inefficiencies. They will support “old” industries and inadvertently starve worthy new areas where job creation could be positive.”* Certainly, we have seen this allocation of tax-payer money to inefficient, non-competitive industries. In the short-term, this was perhaps the only political consensus that could be implemented to mitigate massive job losses (albeit in non-competitive industries such as autos, steel, etc.). In the medium- and long-term, this strategy has done little to solve the core issue of competitiveness and trade-restrictions in most countries. For all the talk of a borderless world, there are still massive trade barriers (masked with rhetoric and justifications) that nevertheless support archaic sectors of production (and lower GDP growth) at the behest of a populist notion of fairness.

There is a spectrum of opinion on the sustainability of any sort of recovery. If we discount the daily noise in the capital markets and focus on the bigger picture of growth potential, we recognize that the social, economic and political framework is still fragile. However, the current political and regulatory environment is quite benign and conducive to positive corporate profits. This concept will drive our portfolio strategy in the short-term.

### **Outlook and Analysis**

We view 2010 as a tricky transition year between immense government intervention and more-targeted government stimulus tweaks. This is a difficult maneuver to achieve in practice. An appropriate analogy is the baton handoff in a 400-meter relay race, an event where the handoff has to be close to perfect or the race will be lost. We see 2010 as this handoff period, but the real impact is from the outcome of what is likely to be a consequent *marathon* that will manifest itself during the course of several decades.

The key is whether any of the current economic recovery is self-reinforcing; in other words, whether progress can be made without

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continued massive government intervention. We are reaching the conclusion that there is a decent probability of a self-reinforcing recovery in many business sectors. *Self-reinforcing does not mean placid.* We expect volatility; we expect that there will be days/weeks/months of strain in the capital markets in general, and more noticeably in specific sectors.

Amid some signs of optimism, it is not easy to ascertain clearly what portion is discounted in current capital markets prices; prices are not cheap (if one factors in 'normal' levels of the cost of money, interest rates). However, this is an environment with low actual inflation (in certain areas of the economy, deflation is the stronger force) and low labor and capital capacity (meaning a lot of room for growth without detrimentally impacting inflation), very loose economic policy, and a lot of cash looking for alternatives to very low government bond yields. The return-on-equity across sectors is recovering, although still low by historical measures. If we evaluate a medium-term horizon, and assume that the price-to-earnings multiple on the S&P500 remains around of 15 (it is about 14.5 currently) we would expect an 8% average annual return for the broad equity market, or a long-term return of about 10%. In practice, we think that there will be a great deal of variance within the broad equity market, with certain sectors out-performing and other sectors underperforming – within a larger-than-normal range.

The two biggest **macro risks** that we can identify now are centered on political and regulatory policies. We conclude that the massive global stimulus efforts have been a great short-term assist to recovering corporate profits (this is obvious, not a particularly erudite comment). But we also note, this has done very little for household wealth or consumer confidence. This means that gradually improving GDP growth (probably below the underlying potential due to the deteriorating opportunities caused by massive government intervention, but still a marginally positive trend) means that there is room for corporate profits to grow. Any surprise slowdown in these stimulative efforts (particularly in China) would be detrimental short-term to global GDP growth and employment. Unemployment and underemployment are of particular concern. Even fear of job cuts has a tendency to stifle consumer spending and re-balance the portion of household wealth directed towards savings and spending. Although consumers have probably reached their limit on leverage in the short- and medium-term, this does not prevent a recovery in consumer spending, only a sub-par recovery by historical standards. So we continue to evaluate whether the handoff that we referenced earlier will be smooth or rough or somewhere in between (a fumble but not a dropped baton).

We are acutely concerned about the **populist political rhetoric** (not just limited to the United States, although the U.S. has taken a lead role) that has a tendency towards far-reaching policies that, in the interests of social and economic redistribution, hobble entire sectors of the economy. In particular, we are focused on how the current political environment will affect the regional and global banking industry. The pain related to residential housing and securitization that has been very visible for the larger, global banks is now becoming more visible and painful for the regional banks. For all practical purposes, the banking industry is still in a recovery period – one of healing, not thriving – despite the near-record liquidity and the record low interest rates foisted by governmental edict. We are monitoring this sector closely to understand whether the slowing velocity of money and restrictive across-the-board lending is trending higher or whether political oversight will squash any sense of modulated risk-taking (which is the primary business of a bank). We would not be pleased to see an escalation of hostilities with Wall Street – not because we think that Wall Street is being unfairly targeted but because finance is so critical to the economy and fiddling with this is akin to playing with fire in a forest during drought conditions.

We bifurcate our corporate profit analysis between larger firms that have access to low-cost financing and smaller firms (less than 50 employees) that still are having a difficult time with financing their operations and growth. These smaller firms are not hiring back full-time workers and they are not growing at their optimal potential. We expect to see continued business failures and mergers within the smaller firms during the course of the next several years.

For now, corporate profits of large, global firms are recovering (prospering in many cases due to access to very low-cost borrowing), balance sheets have been significantly de-leveraged, and capital expenditures are again picking up (after having been slashed to free-up capital for debt service). We expect to continue to see consolidations within sectors as more operationally efficient companies gain or acquire market share. In particular, we expect merger activity to pick up in Healthcare, Technology, specialized Energy services, and Industrials -- sectors that are purposefully in our client portfolios.

We continue to invest in the **Healthcare** sector. With a price/earnings-per-share (P/E) ratio of 11.7 – compared to a ratio of 14.5 for the broader S&P500 index – this is a cheap sector relative to historical P/E ratios. Unfilled product orders (new orders versus inventories) are at multi-year highs and export markets have revived. The secular risk here is the risk that sales growth may be slowing. But we see enormous opportunity outside of the developed world markets, that should provide sales growth in the future – the key is to have exposure to this growth outside of the developed markets. The regulatory risk to the broader healthcare sector is over uncertainty about the outcome of healthcare reform legislation. Recent political events have moved this uncertainty closer to certainty of delay. Furthermore, the specific investment for our client portfolios is dominated by pharmaceutical companies, which are more sheltered from the healthcare reform efforts of the Obama administration.

The **Utilities** sector has been a core holding for client portfolios during the past several years (with a brief hiatus in the first half of 2009), and we expect it to continue to be a core holding, albeit with its own set of risks. This sector has a mixed history of performance, underperforming the broad market during the early 1990s (due to a focus on high-beta sectors) and during periods when bonds are highly overvalued. The higher-than-average debt levels (at least compared to other non-financial sectors) are not comforting during a period of deleveraging. However, this is a natural investment for income-oriented investors, especially in a deflationary period with low prevailing interest rates, providing a base level of investor demand. This sector has a P/E of around 12.3 and a price-to-cash flow around 5.7 (versus 8.0 for the S&P500) coupled with a yield of over 4%, making it an attractive investment. Sales and earnings should continue to predictably increase (there are rarely earnings surprises in this sector) as industrial utilization increases. Clearly, if electrical production is subdued due to a weak outlook for construction and industrial inventory rebuilding, earnings may also be subdued. The other risks are from environmental regulatory changes (although we expect these to be minimal), competition from alternative energy sources (although many traditional utilities are investing heavily here) and perhaps the most acute problem, tax policy changes. As higher taxes on dividends are likely realized in the next tax law change (in year 2011, unless Congress acts more rapidly), the relative advantage of holding high-dividend paying stocks may be minimized. However, given that the tax law changes in the U.S. have been known for the past eight years, we do not expect to see any sustained adverse consequence of higher dividend taxes. In other words, we think that this change has already been priced into current valuations.

We are also interested in (and invested in) the **Technology** sector as the higher-beta component of client portfolios, given the global scope of revenue and the continued trend towards corporate efficiency (i.e. replacement of labor with capital and technology). There is

some disagreement regarding the durability of earnings in this sector. The sector short-interest ratio (i.e. ratio of stocks sold short to total stock outstanding) has moved up since about November 2009. However, insider purchases have increased since November. We place more credibility on insider purchases, although we recognize that continued appreciation in this sector is based on continued global expansion, which is not guaranteed. The forward earnings estimates are somewhat aggressive, although globally-oriented firms have continued to meet or exceed these estimates (and many have continued to raise these estimates).

**Industrials** is a new investment sector for Advocate, although we have been monitoring this for some time now. In particular, we are invested in globally-oriented industrials that derive a portion of their revenue from providing products and services to the alternative energy field (hydro, nuclear, wind, geothermal). Most exposure is outside the U.S., with an emphasis on China, Spain, France, Germany and Japan. Unlike our theme for core investments in Utilities and Healthcare, this is not a cheap sector, with a P/E of 24 and a price-to-book value of 1.9. We expect that as governments re-focus on non-carbon based energy sources (already gaining momentum outside the U.S.) this sector should benefit. This is clearly a hedge against higher oil prices (coincident with increasing future demand, which is somewhat lackluster now).

Other than a brief hiatus in the first half of 2009, we have been invested in **Oil/Gas Equipment and Services** for about two years now. This sector has been appealing at a time when not only the price of oil has fluctuated greatly, but also at a time when the cost of oil exploration and extraction has been increasing (a positive for this investment). The Energy sector as a whole is quite cheap on a cash-flow basis (let's face it, cash flows are very high). This particular sub-sector has a P/E of about 15.9, not cheap, but a price-to-book value of about 1.7, about the same as Utilities and Financials, and rather cheap by comparison to the other sectors. Having said this, we are concerned about the lack of significant demand growth and the anecdotal evidence that the stored supply of oil is high (in other words, a lot of room for demand growth before prices have to adjust upward). We have a conservative sell target on this sector.

We do not particularly like country-based investing in this market cycle, but **Chile** has been compelling for some time now. We invested in mid-2009 after following this region in general and this country in particular for some time. Chile has been a well-run economy, thanks in no small part to a decade of prudent economic decisions. No matter which politician has been in power since Pinochet's ouster in 1990 (it has all been under one center-left political party), both major political parties have supported balanced budgets, rule of law, respect for property rights and an open economy that has resulted in heavy foreign direct investment. (Chile has the highest export-to-GDP-ratio in the world.) Prudent fiscal discipline does pay off, although one has to accept a longer-term view than most countries are willing to accept (certainly longer than the four-year presidential cycle in the United States). Chile's recent acceptance into the Organization for Economic Cooperation and Development was recognition of this, and a reinforcement that a free-trade economy can prosper. With the recent election of a new president, Sebastian Piñera, we expect the pro open-market approach to continue. Our specific investment in Chile is focused on four main sectors that compromise about 78% of this investment – Utilities, Materials (mainly copper), then Industrials and Financials. While the Utilities component provides the same core exposure as in the United States, clearly the benefits and risks for the other major sectors are linked to a growing global economic recovery.

Although there is always a risk in equity investing, we believe that the more defined risk now is on the **fixed-income** side. There is still a sense of uncertainty regarding monetary and fiscal policies, and this will create upward pressure on yields on the longer-end of the bond curve. Furthermore, as governments issue more bonds in 2010 to fund deficit spending, and as

demand for private corporate debt continues to increase, this will also place upward yield pressure on the longer-end of the bond curve. However, we think that the spread between government and non-government bonds should continue to adjust downward from current higher-than-normal levels. Therefore, we think that spread-based and higher-beta investments should be a good focus. This includes Corporate bonds (already in client portfolios), High-Yield bonds (not currently in client portfolios), and non-U.S. bonds, particularly in developing markets, (already in most client portfolios).

We are also focusing our debt exposures on taxable municipal bonds as a portion of fixed-income portfolios. These are very compelling for taxable and non-taxable investors alike, as the yields are comparable to investment-grade corporate bonds (higher, actually) and the default rates are lower. As long as the U.S. government continues to subsidize municipalities (conceptually, in a similar fashion that the TARP program subsidized banks), this investment should provide an attractive yield.

In addition, we have invested in two hybrid investments that are appealing when there is uncertainty in the capital markets and low corporate borrowing costs. In particular, in August 2009, we invested in **convertible securities**, which provide an attractive yield while also providing exposure to the equity-like upside returns. During the past several months, this investment has been comparable to the broader S&P500 return with a higher yield. The risk to this investment is that if risk tolerance completely collapses again similar to 2008 or if the traditional source of demand for convertible securities (hedge funds) no longer trade in these securities – although we think these are lower-probability scenarios.

We have also recently invested in **preferred stock** of mainly financial (but also some industrial) companies. This type of investment pays fixed dividends (currently yielding around 6.8% for our particular investment) and has seniority before any common stock dividends are paid out. It has no voting power like common stock, and does not have seniority in dividend payout over common stock. But it does take precedence over common stock in the event of liquidation. Preferred stocks can be highly customized and carry all sorts of convertibility provisions. They are attractive for corporations to issue because they provide flexibility in financing their operations. We like this type of investment because it provides an appealing yield in sectors that have high profit margins and that low private borrowing costs. We view it as a proxy for the Financials sector, with less volatility at a time of regulatory uncertainty. The risk here is that populist politics will drastically alter the business environment for banks.

**Deficits** are a vital issue. We are not alone in pointing out how onerous will be the monumental deficits that all governments have accumulated. It is difficult to understand with any level of certainty what sort of impact this would have in the short to medium term. At the very least, we expect many new fees and taxes in future years, at the federal, state and local level. We would also expect a higher cost of capital over the medium term (in the form of higher government yields for medium- and longer-duration debt). Perhaps this will be coupled with a gradual shift towards issuing more inflation-protected debt (such as TIPs) as a mechanism to offer our sovereign creditors some protection against inflation. **Inflation-protected Treasury debt** is certainly a portion of our current fixed-income portfolios. (In spite of the current inflation outlook being benign, the operative time frame for these investments is closer to five years – at a point that we consider to be more inflationary than now).

In summary, we believe that year 2010 will be one of self-reinforcing economic upturn (gradual, and continuing over multiple years), as fiscal stimulus is reduced. Even though fiscal policy actions appear inflationary, the short-term underlying economic conditions are more

deflationary, so we expect a form of inflation in asset prices in the short-term, but not so much in goods or services (perhaps with the exception of Healthcare, where we would expect to see goods and services price inflation). Over the medium term, we expect current policy actions to form the basis of the next crisis (another bubble). Over the long term, we will want to closely monitor the velocity of money (currently very low and deflationary) to understand whether inflation is emerging as a real and sustainable threat to prices and currencies (certainly the U.S. dollar versus developing economies).

### **Client Portfolios**

For Advocate, the key to the past twenty four months or so has been to calibrate portfolio risk and return through the prudent use of cash, a first level asset allocation decision (in our lingo). However, this is not an efficient long-term type of calibration and is, in our thinking, only to be used during particularly uncertain periods of time. We view the key to 2010 as calibrating portfolio risk and return through the use of our second and third level decisions, the selection of investment sectors (in equities), and the selection of bond qualities and durations (in the fixed income area). We are moving client portfolios towards neutral equity levels (which vary by client in accordance with their overall risk preferences) and intend to mitigate capital loss through sector selection with high earnings quality and transparency, and a focus on hybrid investments that provide a level of equity-like upside while providing some level of debt-like downside protection.

Client portfolios were refocused away from protection at the beginning of the year (with high levels of cash and high-quality government bonds) to low levels of equity exposure mid-point in the year (although to sectors with higher-quality, more predictable earnings) and finally towards higher levels of equity exposure towards the end of 2009 (focused on a more neutral investment policy with broader equity and debt exposures). This paid off well in January and February 2009, when client portfolios were down in the low single digits compared to losses of 20% for the broader equity indices. We did re-commit to the equity markets more during mid-March, just in time for the vigorous run-up in equities, but nowhere near neutral equity levels. In hindsight, more anticipatory and aggressive thinking would have paid off better for client portfolios. However, we have to balance this hindsight with our primary focus to protect client principal.

The fourth quarter in particular was an important period of transition for client portfolios. After being invested in a relatively protective fashion for much of the year, we closed out our broad equity and U.S. dollar hedge positions in October. This effectively increased equity exposure. In November, we re-focused away from aggressive positions in residential Real Estate and Basic Materials to Technology and Utilities. In December, we added to existing positions in Healthcare, which we have been accumulating throughout the year.

Other than tax-related issues at year-end for certain taxable client portfolio, equity exposures in client portfolios ended the year in domestic and international sectors. Domestic U.S. exposure was in Utilities. In the globally oriented investments, equity exposure was in Technology, Healthcare, Industrials, and a country fund, Chile (invested mainly in Utilities and Basic Materials, with an emphasis on copper extraction), and Oil/Gas Equipment and Services. Portfolios were biased throughout the year towards non-U.S. dollar earnings, which is helping investments biased to currencies other than the U.S. dollar. Many of the underlying companies in client portfolios are listed on U.S. exchanges, although their revenue sources are global, so we prefer to view exposures from the perspective of revenue, not from exchange-listing domicile.

For client portfolios with fixed-income exposure, any position in short-duration U.S. Treasury bonds were sold and re-allocated into existing positions in hybrid convertible securities and new

positions in taxable municipal bonds. These municipal bonds have similar yield characteristics as investment-grade corporate bonds, but with historically lower default risk (important if things go awry in 2010). Although we do not think that municipalities are free of financial, employment and other problems, their taxing capabilities places them at an advantage over private enterprise. Furthermore, the taxable nature of these bonds extends their interest outside the traditional tax-exempt municipal investor base, a positive aspect for demand.

Geographic debt exposure exposures ended the year at about two-thirds in U.S. debt (investment-grade corporate, inflation-protected and agency debt), and one-third in non-U.S. debt (inflation-protected and emerging economies). These investments expose portfolios to the debt markets of the U.S., U.K., France, Germany, Brazil, Russia and Mexico, as well as other emerging market countries to a lesser degree. In early 2010, we liquidated exposures to Agency, Credit and non-U.S. inflation-protected debt, and re-allocated into investment-grade corporate bonds, taxable municipal bonds and more hybrid investments in preferred stocks.

### **Concluding Thoughts**

We thank you for your support and confidence in Advocate.

Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook.

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