

Tactical managers are back.

In the 1970s, pension committees looked to overlay strategies to add alpha and to control portfolio drift. These managers used options and futures to participate in market advances and protect against losses. Then risk went on a 20 year holiday and tactical managers fell out of favor.

In the 1980s, investment decisions were transferred from pension committees to employees. Rising stock prices masked poor plan utilization. Legislators and regulators, aware of the demographics, introduced QDIAs to improve asset allocations, savings, and participation.

And then the system broke down.

In 2008, all funds, all categories, and all international markets zipped and zagged together. This exposed mean reversion models to a "Black Swan" event (see "Black Swan" and "Fooled by Randomness" by N.N. Taleb). Whatever trust that was re-established after the dot.com, Enron, and fund scandals is being tested as investors, including active legislators and class action lawyers, open their year end statements.

Participants never asked to be Wall Street gurus; they just wanted someone to do it for them. Someone looking out for the little guy, not a party in interest locking-in QDIA allocations towards their highest fee funds – because their Monte Carlo simulators say a 2008 can't happen.

This section of the Center for Due Diligence tracks the re-emergence of tactical managers on the scene. We define tactical managers here as those who follow prudent, identifiable methodologies, not 'finger in the wind' market timing. As the CFDD is retirement focused, we will only (1) track money managers with no ERISA conflicts who (2) comply with PPA Section 624, prohibitions against 100% stocks to 100% cash, swings.

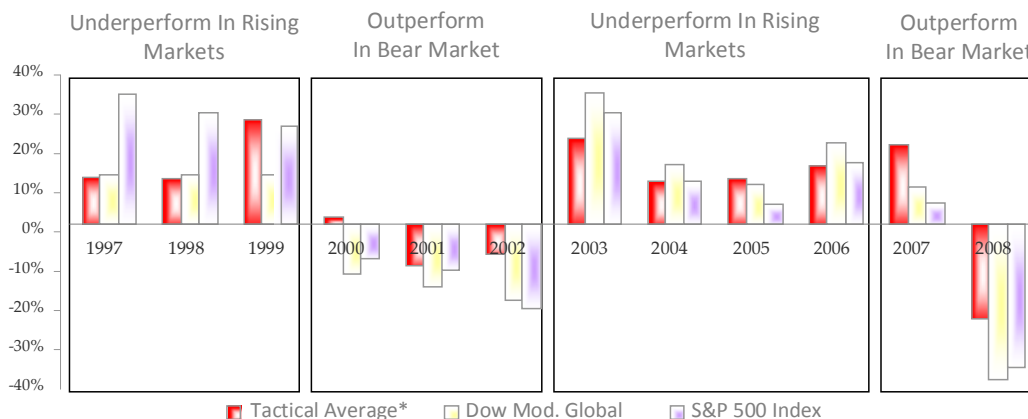
Positions to Consider *Data as of 1/2/09*

Domestic Equities: Under	Sector Ranks/Weightings vs S&P 500 to Consider	
International Equities: Under	1 Health Care 14.63%	6 Telecom Services 3.82%
Bonds: Neutral	2 Cons Staples 12.68%	7 Financials 13.08%
Cash Equivalents: Over	3 Utilities 4.20%	8 Materials 3.01%
	4 Industrials 11.17%	9 Consumer Discretionary 8.50%
	5 Information Tech 15.47%	10 Energy 13.46%

Category Update

During the 'pre-credit crisis' years of abnormally high returns at low risk, tactical managers tended to exit markets too early and stay out too long. Poor results pushed most of the original 1970s group to retirement or to manage hedge funds. As we return to a 1970s-type environment of moderate gains at high volatility levels, surviving tactical allocators are returning to favor, as their strategies were designed to work best in these markets.

Tactical Managers "Pre-Credit Crisis"



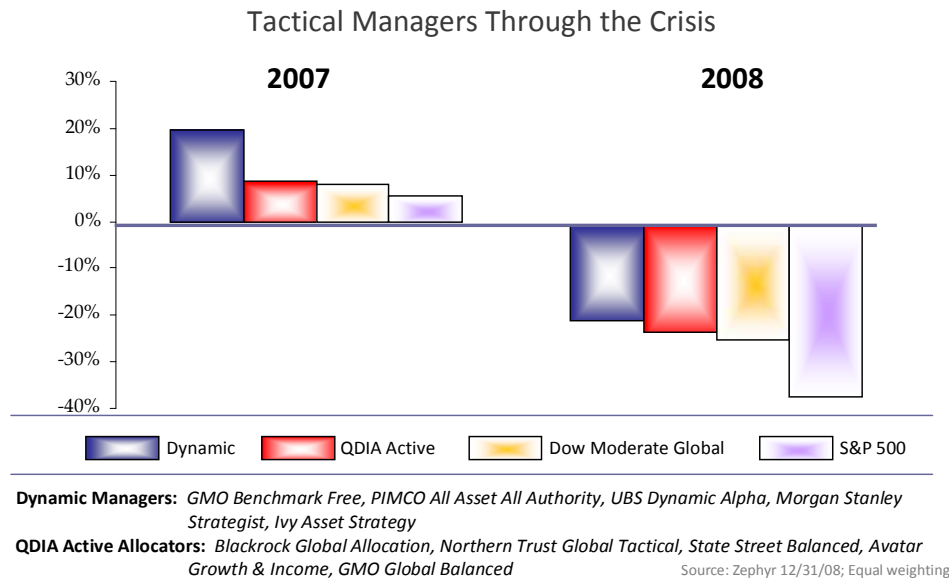
* Equal weighting of GE Strategic, Blackrock Global, Morgan Stanley Strategic, Waddell & Reed Asset Strategy, GMO Global, Shepherd Fund, State Street Balanced, Ivy Asset Strategy, Avatar G&I . Source: Zephyr 12/31/08

As John Bogle of Vanguard likes to point out, a tactical manager has to be right twice – first on when to exit the market and second on when to get back in (“The Little Book of Common Sense Investing” by John C. Bogle, 2007). It is useful, then, to divide tactical managers into two groups. First are the fully dynamic managers that so aggravate Mr. Bogle. This group, which we will call Dynamic Managers, has no benchmark mandates and may swing from 100% cash to 100% equities, with futures, options, and derivatives sprinkled-in.

Less irksome to Bogle, and for that matter, fund company balance sheets, the United States Department of Labor, and Section 624 of the Pension Protection Act, are Active Allocators. While this group also adds value by under and overweighting asset classes, such shifts are typically only 10-20% around a fixed baseline; e.g., a 60/40 stocks vs. bonds. Another, often larger source of value for Active Allocators are *intra*-asset class tilts; e.g. more healthcare less financials, more US less Spain, more treasuries less corporates.

As the chart below shows, Dynamic Managers, those with the dexterity to go to cash, performed well in the declining markets of 2007-2008. Active Allocators (called QDIA Allocators here) also performed well, but because they were tethered to their equity baselines, may not have been as defensive as they would have liked.

This may be a good thing going forward. Dynamic Managers did their job during a 40% sell off, but Bogle is right: Now they have to time their re-entry. Because they already have exposure to equities (albeit underweighted exposure) this re-entry risk is ameliorated. This potentially makes Active Allocators a safer and more prudent choice after such sell-off we saw in 2008.



A word about fiduciary compliance: The Department of Labor has stated that investment strategies fully allocated to either equities or fixed income/cash do not qualify for QDIAs liability relief under the Pension Protection Act. The statute also states that QDIAs must follow generally accepted investment methodologies. For these reasons, we exclude ‘finger in the wind’ tactical market timers. Additionally, we agree with the Center for Due Diligence’s legislative analyst who states that proprietary lifecycle mutual funds may expose plan sponsors to ERISA prohibited transactions violations. Therefore this commentary will only consider strategies free from conflicts of interest.

Market Overview from a Tactical Standpoint

Corporations have begun to surprise the economic experts who had thought that spending in that sector would be very resilient. In fact, we are going through a typical recessionary retreat in capital and other corporate spending.

Unfortunately, that signals a probable period of continued sizeable employee layoffs. Those job losses seem destined to add to the growing signs of retrenchment by state and local governments. That particular drama appears likely to get to the front pages as California faces some very difficult days ahead. In New York City, even though the mayor has been cutting the budget since the summer of 2007, the decimation of the financial services industry is cutting into payroll and corporate tax receipts, and is raising the real likelihood of a serious bust in both commercial and residential real estate, with its huge negative toll on related taxes.

Our **Economic Liquidity** model has rarely been more bullish. The Federal Reserve has lowered interest rates to close to zero and has begun forcing huge amounts of liquidity into the system. The Treasury is also trying to find ways to put a floor under falling credit market asset prices. While the dollar has suffered a recent bout of softness, it is a good guess that other countries will match our aggressive monetary easing.

Our **Investor Liquidity** model, while still bullish, is somewhat less supportive than in recent months when investors were almost distraught as the credit collapse reached something of a crescendo. At that point, bearishness was very elevated. We remarked at the time that, given the historic nature of the stock market decline, there would probably need to be even more extreme readings for these indicators than for moderate bear markets.

Our **Momentum** model has not been able to move much above neutral. While the market has encountered waves of selling, there is not much evidence yet that buyers have come off the sidelines. Additionally, the damage in the global markets continues and might be reaccelerating.

Our **Bond** model is becoming more positive for corporate credit. This is measured more clearly in the potential for improvement rather than in its actuality. Still, values are beginning to appear in the high-quality end of that market. We still see no compelling reason to lower our credit standards, even with a record gap in interest rate spreads for junk.

Equity Update:

Finally, a somewhat calm month. With the exception of the Dow Jones Industrial Average, which was down less than a percent for the month, the other major indices were up modestly. For the year, the S&P 500 was off 37%, the Dow 32%, and the NASDAQ 40%. With the exception of the Dow, the others were down more than 50% from November, 2007, to November, 2008. While the year was certainly one for the record books in many respects, the declines came with breathtaking volatility. As measured by the S&P Volatility Index, (VIX), volatility went from 20 at the beginning of 2008, which was twice that of twelve months before, to almost 90. In November, the most volatile month of the year, daily swings in the market that added up to 25% of the value of the S&P were routine. Fortunately, December displayed remarkable calm in comparison. Not surprisingly, "growth" stocks finished the year significantly underperforming "value" stocks. Until very recently, our Sector Strength model pointed convincingly to non-cyclical groups. While this may be changing, we remain skeptical of a cyclical recovery any time soon.

Not surprisingly, the top performing groups for the year were the staples sector, followed by healthcare, utilities, and telecom services. In December, three of these groups found themselves at the bottom half of the sector list as markets calmed. While the staples companies experienced rising input costs during the year, most, like CVS, Campbell Soup, Clorox, and Coca-Cola were able to actually increase earnings for the year. Unfortunately, earnings for these stocks, like those in other groups, continue to slow and analysts continue to decrease estimates going forward.

Healthcare companies continued to turn in relatively better performance by simply remaining in the top half of the sector list each quarter. We had been hoping for a recovery in the pharmaceutical names, but these stocks, while better than most, cannot seem to straighten out their pipeline and patent issues. New drugs have been scarce, and old ones continue to roll off patent protection. This group, however, still ranks very well in our sector work.

Utilities turned in fairly lackluster performance during the year, even relative to other groups during the first and third quarters, so it is a bit surprising that this group made it into the top three for the year. What made the difference, however, was that many of these stocks were actually up in the fourth quarter. The sector ended this period with one-half to one third the losses of other groups during the most volatile time for the market. Interestingly, this group was dead last for the month of December. The telecom services group, which consists of very few names (nine in the S&P 500 Telecom Services Index, to be exact), experienced the same fourth quarter effect as the utility group. The telecom services group, however, experienced trouble in the first half of the year as the companies came clean about the fact that they are not purely non-cyclical. The fourth quarter, though, was strong, and the group found itself at the top of the list for that three month period.

The consumer discretionary sector actually made it into the top five for the year. This was really only due to the fact that the stocks had already been beaten down before the year even started. The group had a strong showing in the final few weeks of the year as investors placed bets that the worst news for the group had already come out. As mentioned frequently, we would be careful of analysis pointing to that conclusion until some signs that the economies here, and elsewhere, have bottomed.

The energy group ended the year just below the top half of the sector list, after being the best group of 2007. Oil rocketed to \$140 a barrel in the first half of the year, putting the group at the top of the sector list in the second quarter, only to plummet to \$40, taking these stocks with it in the third and fourth quarters. This group ranks poorly in our SectorStrength model, and we would be leery of any short-term moves for the group. Despite big moves in the cyclical names in the month of December, this group did not keep up. The other purely cyclical stocks---materials, industrials, and to a certain extent, technology (yes, technology!)---were near the bottom of the sector list for the year. The bottom of the list, though, was reserved for the financial names, which kicked off all the fun to begin

with. There are many books on the shelves already, and will surely be many more explaining why that was the case, so we will refrain from any history lessons here. Suffice it to say, though, that this group will most likely not be anything like what it was for a very, very, very long time. While we are hopeful the market has seen its worst levels, we are still taking a cautious stance looking ahead into the first quarter of the New Year. As we ponder the data, and watch this market, we will approach the task of portfolio management as we always do: with a thoughtful implementation that is well-diversified and pays close attention to the risks we see in the marketplace.

Fixed Income Update

In the years before the Great Depression, economists Simon Kuznets and Joseph Kitchen began to formulate the understanding of the elements of what takes place in an economic cycle. Their focus was on the shorter-term cycles we now call the business cycle. In contrast, most economists before these two were concerned with long cycles such as in trade, housing and demographics. Both Kuznets and Kitchen emphasized the key role played by the creation and use of business inventories. In the decades following their work, particularly in the post-war period, unwanted inventory accumulation and subsequent destocking was thought to be the biggest source of instability in the business cycle. Gradually, businesses focused their efforts on better ways to control these inventory swings. These efforts included improvements in transportation and shipping, better technology and, importantly, more sophisticated financing.

Many of these innovations were first introduced in Asia, especially Japan, where "just-in-time" was the label given to the process of having parts arrive at an assembly plant not a minute before they were needed. All up and down the supply chain, inventories were pared in relation to sales. American manufacturers quickly applied the necessary techniques and inventories have become a relatively stable part of the business cycle -- until reappearing in this recession. Both here and abroad, inventories have jumped dramatically in relation to sales.

There should be little doubt in the current environment that the sizeable increase in the inventory-to-sales ratio is a surprise and, as always before, unwanted. Certainly an unexpected sharp drop in demand kicked off the process, but as credit has evaporated for businesses, the prior decades of inventory calm has been shattered. Businesses are cutting back production rapidly in an attempt to get stocks down. This helps account for the rapid rise in unemployment. Yet, as labor loses income, they also lose the ability to buy the very goods which would help lower the excess inventories.

Until a floor is placed under the demand for goods, the economic cycle is likely to continue to look lower. While the economy is generating this degree of slack, inflation pressures are unlikely to increase. Thus, bond holders should be relatively calm about demanding an inflation premium. But the depressing effect of the cycle also puts pressure on the credit-worthiness of business units. As we have for almost two years, we continue to recommend only high-quality bonds, recognizing that the lowest quality bonds appear to offer high yields. The trick is to make sure those companies continue their operations. This, in turn, will allow the service of the debt that promises those high yields.

We welcome your comments and questions:

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About Avatar

Pension funds and individuals have looked to Avatar for tactical overlay and global risk rotation investment strategies since 1970. The firm is now extending its proven techniques to 401(k) and other retirement savings plans. Since senior management includes both the architects of the Pension Protection Act's business processes and respected tactical portfolio managers, Avatar QDIAs are designed to reduce both market and fiduciary risks. Unlike most lifecycle, balanced, and managed accounts, Avatar allocations are actively managed, deliver consistently strong returns, have no conflicts of interest, and are priced at institutional fee levels.

Active allocation, low fee, transparent, no conflicts

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