

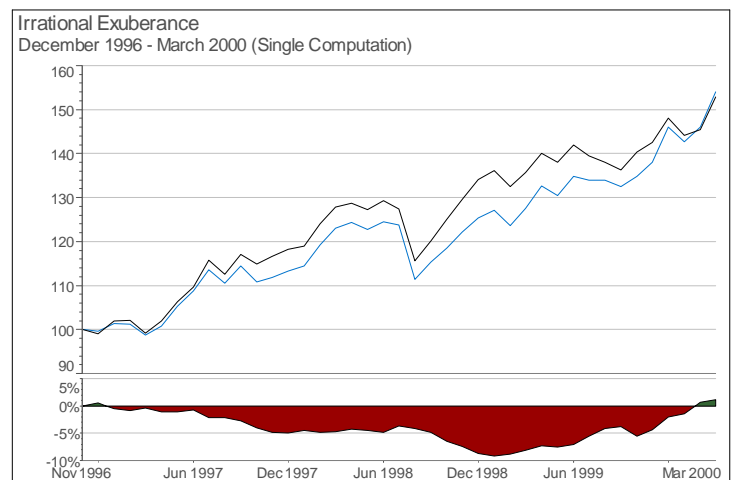
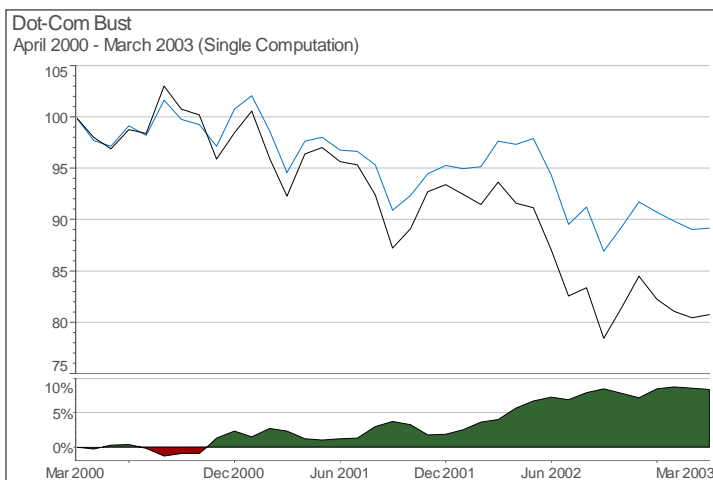
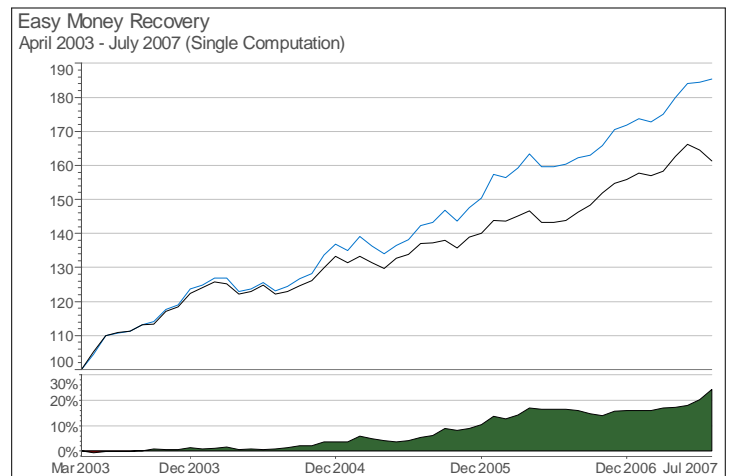
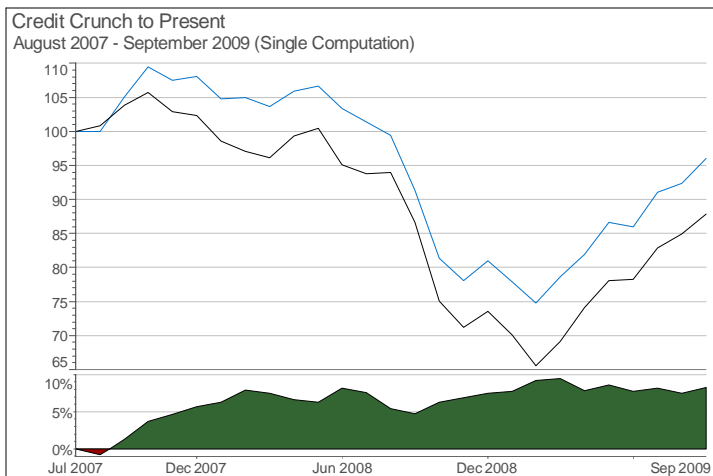
Tactical managers are back.

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 zigged 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, opened their year end statements.

This section of the Center for Due Diligence tracks the re-emergence of tactical managers. 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.

Category Update

The following is a summary of the managers' collective performance over recent market cycles, as analyzed by Zephyr Associates. The blue line is the Long Term Tactical Composite* and the black line is the Morningstar Moderate Allocation index.



* Avatar has developed a number of composites for CFDD tactical commentaries that are populated with leading tactical managers. Managers in our Long Term Tactical composite have greater than a ten year track record in this equally-weighted blend. Funds include Avatar Income & Growth, UBS Global Allocation, SSgA Life Balanced, Northern Trust Global Tactical, Ivy Asset Strategy, Morgan Stanley Strategist, GE Total Return, BlackRock Global Allocation, GMO Global Balanced.

Active allocation, low fee, transparent, no conflicts

A Tactical Review of Global Markets

By several measures, analysts are forecasting the greatest percentage rise in earnings ever over the next twelve months. Of course, the decline in profits was also the greatest in at least 70 years and so a big rise should not be all that surprising. Companies are beginning to think in terms of longer-run strategies and projects. There has been a flurry of mergers and acquisitions, distinctly unlike recent history, however. Rather than being driven by complicated financing schemes, the current bout of activity is more strategic in nature as reflected in the direct involvement of company managements and almost complete absence of private equity financiers. Companies are trying to find good fits for their market strategies, not just ways to make a few bankers rich. The anecdotal evidence is that this is a new phase which investors have yet to appreciate. Rather, the general level of caution remains high as many investors have little faith that a durable, robust recovery is sustainable. Equity markets typically do well in this kind of skeptical environment.

Our **Practical Value** model remains in a neutral zone. Although not normally a plus, we find that the current sizeable pickup in corporate offerings of equity accomplishes two things. First, it improves balance sheets and, secondly, it represents some badly needed signs that corporate managements are beginning to come out of the foxhole and start to think in longer-run strategic terms. In a related move, corporate insiders have started to inch back into a buying mode. Over the summer, insiders had moved closer to net selling than they had been in many years. Other measures of valuation are about neutral. While no longer suggesting the market is cheap, these indicators are very far from suggesting the market is overvalued. It will be important to monitor these measures as profits begin to recover in earnest.

Our **Economic Liquidity** model has improved a bit more from its neutral level. The Federal Reserve has signaled it intends to keep liquidity ample for the foreseeable future. While the dollar inches lower, there are many signs that this weakness is more of a reflection of risk appetites rising than a revulsion of the currency. Traders are using the dollar as a source of credit to invest in much higher yielding currencies. Even so, the dollar weakness so far has been moderate.

Our **Momentum** model has generally moved higher, even with occasional air pockets. Market breadth and the expanding list of stocks trading at new one-year highs show a good quality market. Group participation has also been broad and hinting at a shift to higher quality sectors as the economic recovery story gains followers.

Our **Bond** model improved as the inflation data continued to be benign, even as economic activity is recovering. The degree of slack in production facilities and labor utilization are at a record and it is unlikely that an inflation episode can be sustained. As profit conditions become very favorable, credit quality can improve. We continue to like good credits and are willing to maintain Treasury positions for a period ahead.

A Tactical View of Fixed Income Markets

Bond investors have increasingly worried about signs of revival in the economy, fearing that private sector demands for credit will just add to the public sector borrowing involved in the Federal stimulus package as the budget deficit climbs inexorably to new record heights. The health care debate along with initiatives for energy management only adds to fears that federal spending (and therefore borrowing) could be on an ever upward path. At the same time that private sector credit demands may begin rising, there are intriguing signs that global economic excess liquidity may not be nearly as abundant as in the days of the credit bubble. Countries like China are not generating the amounts of export earnings which fed the growing appetite for mortgage and other credit instruments. With import demand in the United States dropping sharply, the ready supply of credit in the global system has likewise dried up.

In every recovery in the post-war period, there have always been fears of crowding out. The budget typically goes into deficit and federal borrowing rises. But history clearly shows that there really has never been any sting to the deficit. The reason is that private sector credit demands are simultaneously

dwindling. As recovery sets in, tax revenues rise and private borrowing has to compete with diminished budget deficits. We see no reason the same will not be true this time around. In addition, we think there is another factor which will work to further avoid the clash in the credit markets. The Great Recession has

led corporations to be brutal in slashing costs. We have a record layoff of workers. Inventories have been cut to the bone. Projects have been delayed and abandoned.

The most tangible funding factor revealed in the corporate sectors is that the difference between cash flow and capital spending has surpassed all prior experience. The result of this change is that when recovery starts to get to the point of encouraging capital spending and new projects, the first phase (and perhaps more) can be totally self-financing. Rather than tapping the bond market for new funds, corporations can meet their needs from their own treasuries.

A corollary for this period of flush corporate coffers is that defaults of lesser quality credits ought to be fewer than implied by the severe recession. In all, we continue to view the corporate side of the credit lineup to be attractive over the longer-term.

We welcome your comments and questions:

Michael Case Smith
Senior Vice President, Institutional Strategies
Avatar Associates, LLC
575 Lexington Avenue, 8th Floor
New York, NY 10022
212/ 624-1903
msmith@avatar-associates.com

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

AVATAR
ASSOCIATES

This document is for informational purposes only. The assumptions and parameters used are not the only ones that might reasonably have been selected and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosure or analyses. All opinions and views expressed constitute judgments as of the date of this writing and may change at any time without notice or obligation to update. The information contained herein is not and shall not constitute an offer to sell or a solicitation of an offer to buy securities in any of the products referred to herein. Any offer to sell such shares or other securities can be made through an investment prospectus and an advisory agreement only.