



I'll Take the Stairs, Thanks.



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There's an old saying on Wall Street that the stock market takes the stairs up and the elevator down. After nine painful months, global stock markets got off the down elevator in March 2009, walked right past the stairs, and hopped on the escalator going up – most benchmarks rose nine of the last ten months of the year. For the full year, U.S. and foreign stocks rode their way to gains of 26.5% and 32.57% respectively, as measured by the S&P500 and MSCI EAFE indices.

Stocks weren't the only asset class to provide handsome returns. With the exception of U.S. Treasuries, most categories of bonds returned between 5% and 15% for the year, with corporate bonds, especially High Yield, returning more than that. Commodities and Global Real Estate securities, both of which were hammered in the 2008/9 bear market, came storming back for the year, with some funds in these categories returning nearly 40% for the year.

While 2010 is only a few weeks old, we have already been reminded that the down elevator

still works, as evidenced by a three day drop of ~550 points in the Dow Jones Industrial Average during the third week of the year. A sudden decline of 5% should hardly be surprising following a 60% rebound from the March '09 lows. In fact, following such a run, I found myself at the start of the year actually



hoping for a normal stock market correction of 10% - 12% in the first half of this year. Why? Because whether or not we can return to a more "normal" environment is one of the most

important questions facing investors today. A normal short-term correction in the context of a normal long-term recovery would be a very positive development.

But what are the chances? The catalysts for last week's volatility lead me to believe that 2010 is unlikely to be normal. First the Chinese government announced that it is seeking to curb lending to cool its economy. Then the Obama administration revealed plans to limit the proprietary trading activity of banks.



Mr. Stock Market didn't like either of these developments. The markets sold off further the next day when rumors began circulating that Federal Reserve Chairman Ben Bernanke

may have difficulty getting reconfirmed for a second term. The Chinese government slowing growth. The government changing the rules for the financial services industry. A Fed Chairman not getting reconfirmed. This unusual variety of triggers doesn't necessarily portend a negative outcome for the year, but to me it does serve clear notice that this year may be characterized by increased surprises and volatility.

As far as the economy goes, the news has hardly changed over the past several months. The U.S. economy is growing again, albeit in a tenuous fashion. Optimists point to consistent historical patterns during which the degree of the last ten economic recoveries has been closely correlated to the magnitude of the preceding recession. If this cause-and-effect relationship holds true this time, we are in for a very nice economic recovery. Stocks could benefit greatly

from a surprising U.S. recovery, increased profit margins, and the continued robust economic growth of developing countries. Pessimists point to the negative consequences of massive personal debt reduction, huge government deficits, stubbornly high unemployment, continued foreclosures, as well as the headwinds of seemingly inevitable increases in taxes and anti-business regulations. Like it or not, and who would, the current investing environment does not lend itself to clarity or confidence. But with short-term interest rates near zero and likely to stay under 1% for quite a while, it doesn't lend itself to keeping assets in cash either.

In times like these, when the near-term can be so unpredictable, it can be useful to maintain a longer-term perspective. In this regard, the close of 2009 marked not just the end of the year, but the end of the first decade of this century. Some pockets of the press have seized on the negative 9.1% total return of the S&P 500 index to proclaim it a "Lost Decade" for investors. But like the many plot lines of the TV show *Lost*, it's just not that simple. Foreign stocks returned 17%

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for the decade, hardly an attractive total return considering the volatility, but still much better than the returns of U.S. Large Cap stocks. However, few have reported that Small Cap stocks

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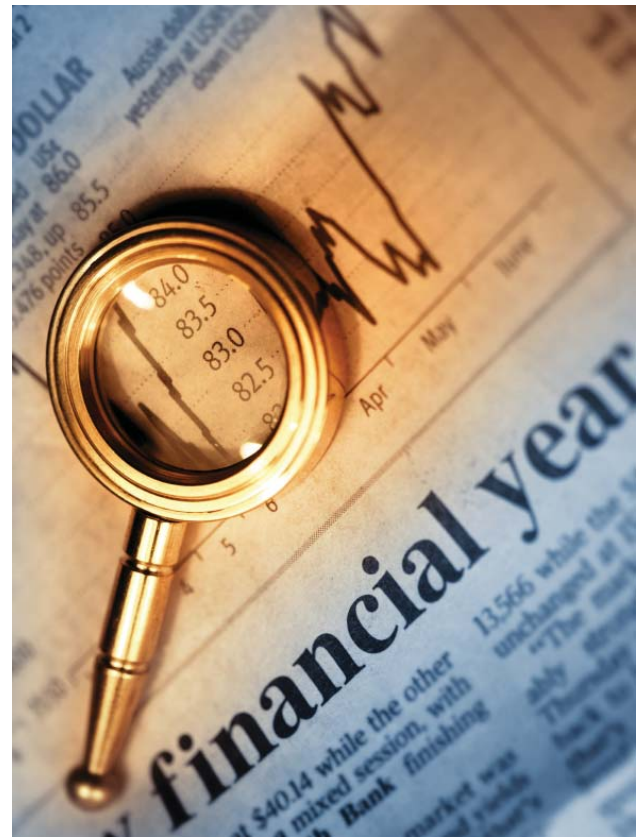
rose 41%, Commodities gained 51%, Bonds returned 85%, Emerging Market stocks rose 162%, and REITs actually finished 180% higher for the decade! Obviously, it was not a “Lost Decade” for investors with the foresight and the discipline to maintain a well balanced and globally diversified portfolio of stocks, bonds and alternative investments.

One of the lessons of the past decade is to recall the investing environment ten years ago. Back then, with the memory of the 1997 Asian financial crisis still fresh, inflation tame, and commercial real estate dropping 20% from '98 to '99, it was easy to ignore foreign stocks, commodities and REITs and jump on the technology stock bandwagon. For perspective, consider the following excerpt from the March 17, 2000 San Jose Business Journal when Cisco Systems stock market value was worth \$465 billion:

At least one analyst believes Cisco Systems Inc. will be worth one trillion dollars in a few years—and you'd be hard pressed to find anyone to disagree. Thirty-seven investment banks recommend either a “buy” or a “strong buy.” None recommend a “sell” or even a “hold.”

Ten years later Cisco Systems is still a leading technology firm, but its stock market value is now about \$133 billion. The point of course, is that what was true in 1999 is still true today – what may seem certain at the time is often unlikely to come to pass and that successful investing requires you to be diversified, disciplined, and a little bit different from the herd.

Our position on how to invest in this market hasn't changed. For several quarters now we have recognized that short-term risks and opportunities are elevated and have recom-



mended positioning portfolios accordingly. But we do not think it is wise to focus too closely on the next quarter or two. Our investing horizon is long-term and our tactical shifts are typically made with a 2-3 year time horizon. When viewed through this lens, we think your chances for investing success go up, as compared to the investor who is focused too much on today, tomorrow, this week or this month. In that context, we continue to prescribe a diversified, global approach that is underweight both core stocks and bonds, and maintains a meaningful allocation to alternative asset classes and strategies.

As I try to envision writing this letter in January 2020 and looking backward to today, I am reminded of the famous quote from Bill Gates that “We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten.” I am confident that we are in for a lot of change over the next ten years. Even so, I believe our investment approach will help us spend less time on elevators and escalators, and more time on the stairs, whatever the future may bring.



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