Trimming Our Sails for Long-Term Growth, Keeping a Reef at the Ready

Stembrook Investment Commentary – March, 2010

Sailors work to keep their sails trimmed for optimum speed. They also need to be prepared for the occasional storm. One such preparation is being ready to reduce the amount of sails aloft. The term for reducing the size of a sail is, "to reef" and being ready to do so parallels our investment approach today. We are working to grow portfolios as quickly as possible, while keeping our eyes out for potential dangers on the horizon. We are ready to use the tools at our disposal to limit the impact of such risks on your portfolio.

Looking back over a tumultuous period filled with dramatic market moves both up and down (see **Chart 1**), we have seen unprecedented stresses on our financial system and the world economy. Through this period and in the years ahead, the fundamentals of our approach have not and will not change. We continue to focus on three areas of long-term investment value.

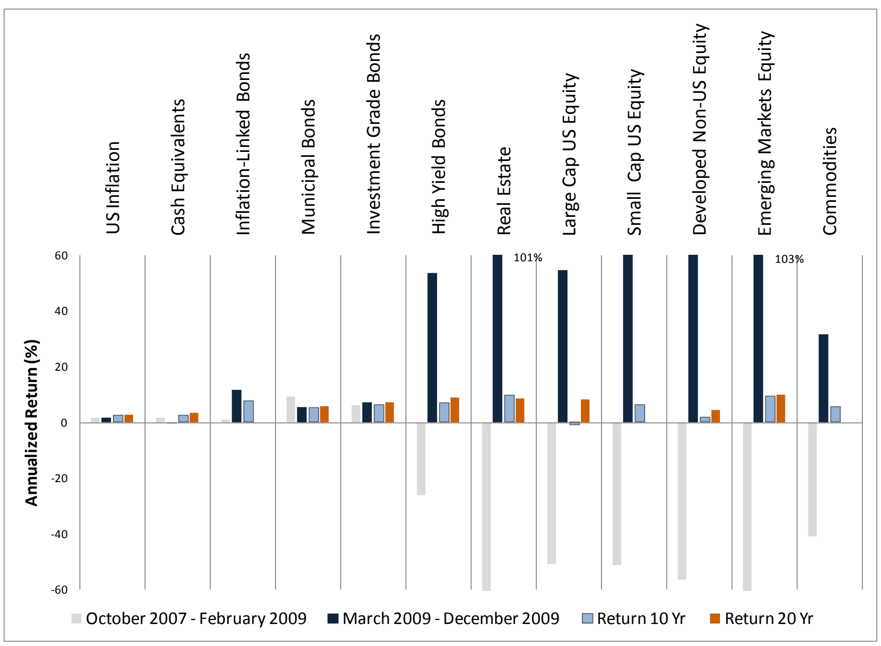
First, our investment planning is used to calibrate your portfolio to your long-term return goals and ability to withstand volatility. This planning was a key factor in allowing clients to maintain their allocations and be fully invested during the dramatic market recovery to date.

Second, we continue to construct portfolios using our time tested investment research in an effort to maximize your returns after taxes and fees. This includes decisions as to when to invest with higher cost "active" managers and when to conserve on fees by opting for a "passive" index approach. Our long-term value orientation is also expected to add to returns over time. For taxable portfolios, we continue to consider the impact of taxes *before* investment decisions are made.

Third, we actively adjust portfolios based on our ongoing asset allocation research. This disciplined approach allows us to identify undervalued investments, while capitalizing on behavioral factors such as fear and greed.

While this past market cycle was a challenging

Chart 1 – Global Market Returns as of 1/31/2010



Source: Thomson Reuters, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index.

Stembrook Asset Management, LLC • 83 Wayne Street, Suite 101, Jersey City, NJ 07302 • www.stembrook.com

one, we have thus far weathered the storm intact and are actively looking for new investment opportunities.

Why Process Matters

Since we usually refer to "the market," and the news outlets talk about "the market," and our charts show returns of "the market," it is easy to lose sight of the fact that most investors' returns don't necessarily reflect those of the market.

Why not? While they do not tell the whole story, two powerful visceral forces remain at work in the human psyche. They are, fear and greed. These two forces explain why investors are more confident in a market that is up 50% than in one that is down 50%, even though under the cool light of reason, people would rarely choose to pay $1.50 for an item that can be had for $0.50. Nevertheless, human beings are still the product of an earlier time when fight or flight meant, "run now or be eaten," not "let's ponder the facts and make a decision after assessing all the information at our disposal." In the time it took to read that sentence, our distant ancestors stood a fair chance of being chased down by a by a truly life threatening beast. The reality is that we are still hardwired to run from perceived danger and need to stack the odds in our favor by using tools and processes to keep us focused and objective. More on this in a moment.

Over time, there have been many studies attempting to calculate returns realized by investors, versus those of market benchmarks. One such attempt is the Dalbar study, which evaluates 20 years of historical market data. In it, researchers attempt to measure returns realized by the average investor, including the impacts of the timing of their purchases and sales. Said another way, the study asks if the average investor tends to buy low and sell high, or buy high and sell low.

So, how has the average investor fared? As it turns out, the average investor has underperformed the market by more than 5% per annum over the past 20 years,[i] a staggering number. In dollar terms, over a twenty year period, a $1million investment compounded at, say 4% would be worth $2.2 million, while a return of 9% (4+5%) per year over the same period would result in $5.6 million. Avoiding the pitfalls associated with our most basic instincts can be worth more than $3.4 million over 20 years.

> "The average investor has underperformed the market by more than 5% per annum over the past 20 years."

Disciplined investing is a long-term process. It begins with a plan, followed by thoughtful portfolio construction and ongoing active management. This disciplined approach gives investors the confidence to weather the storms and come out the other side intact and further along on their journey. We have and will continue to manage your portfolios in this manner.

Capital Market Assumptions

Capital market assumptions, or expected returns and risks for various asset classes, are constructed in an effort to provide a reference point for our investment decisions. These assumptions are built using historical research and fundamental investment theory. From a practical perspective, these assumptions give us confidence when those around us have lost it, and make us skeptical when optimism overtakes reason.

However, there is a limitation to what these indicators can provide. Few to none are predictive in the short-term. In fact, a 7-10 year horizon is where most predictive measures become reasonably reliable.

Table 1 – Capital Market Assumption Comparison

	Stembrook Expected 7-10 Year Returns		Annualized 10 Year Rolling Returns Since 1926		
	As of 3/31/09	As of 12/31/09	Low	Average	High
Equity (1)	10.7	8.7	(1.4)	10.8	20.1
Fixed Income (2)	3.8	3.4	1.3	5.4	13.1
Equity Premium	6.9	**5.3**	(2.7)	**5.4**	7.0

(1) S&P 500

(2) Intermediate-Term Bond

Source: Ibbotson Associates, Standard & Poor's, Barclays Capital, Federal Reserve, Stembrook Research

What do those indicators imply today? They tell us that expected stock and bond returns are below where they were in March. They are also about 2% below the average 10 year return since 1926. This sounds somewhat pessimistic, but it is important to remember that when allocating capital, we are choosing between the options available in today's environment. With very low yields on both bonds and stocks, a lower than average return for both is reasonable. What tends to matter more than absolute levels of return is the relative attractiveness of the options. The bottom row of values in **Table 1** displays the Equity Premium - or the return of stocks over bonds. From this measure, we can see that stocks are expected to deliver 5.3% over bonds, in line with the historical average. This makes stocks an attractive investment today.

It is important to emphasize that these expectations are just that. They are not a guarantee, but estimates with fairly wide ranges around them. However, they do provide a solid intellectual underpinning to our investment decisions. They also help us to allocate capital with an eye towards the future and not on the recent past (a behavioral pitfall to be discussed at a later date).

Fixed Income

Compared to nine months ago, the fixed income markets seem very, very normal. We have experienced very strong returns in high yield bonds and the field is now getting crowded with latecomers. As more buyers move into high yield, yields fall and prices rise. The lion's share of gains has been made in this cycle and we are re-evaluating our position. In fact, after accounting for taxes and expected defaults, we've begun to trim our positions in taxable portfolios.

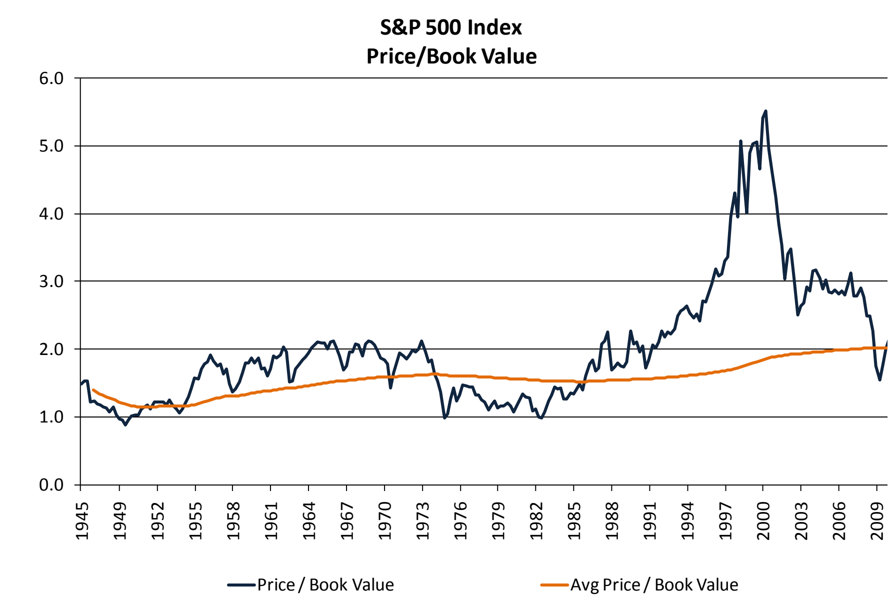
In investment grade fixed income, we continue to maintain a balance between longer maturities with higher yields and shorter maturities with significantly lower yields. We are erring on the side of shorter maturities as a hedge against rising rates. This rise would likely be driven by reduced Fed stimulus, combined with participants in the bond market who, in the face of rising inflation, would seek higher yields to offset the reduced buying power of their coupons. *See our inflation discussion for additional comments.* Active bond management still looks like a good bet and we will continue to own our active manager for a portion of the bond allocation in the form of the Loomis Sayles Bond fund, incidentally, a winner of the 2009 Morningstar bond manager of the year award.

Municipal bonds still represent an attractive investment. Municipal yields stand above Treasuries after accounting for taxes. This is a historical anomaly and reflects investor fears regarding states' fiscal situations. We will continue to monitor this situation, going forward.

Equity Valuations Are Normalizing

In our last commentary, we observed that forward-looking corporate earnings were sufficiently obscured and suggested that other measures be used to evaluate market valuations. The price to book ratio, which is highly correlated with the price to earnings ratio, is a more stable measure because the book value of companies is determined by accounting valuations rather than market estimates. While this is imperfect, historical research shows that today's book value is a good indicator of future returns. With that in mind, we observe the most recent book value in **Chart 2** which hovers close to its long-term average since 1945. As we've said in the past, average is not typically something we strive for, but if investors achieved average returns over the next ten years or more, that would amount to 9-11 percent, something we'd be happy with. For this and other reasons, we have been fully invested in stocks in recent months.

Chart 2 – US Stock Market Valuations



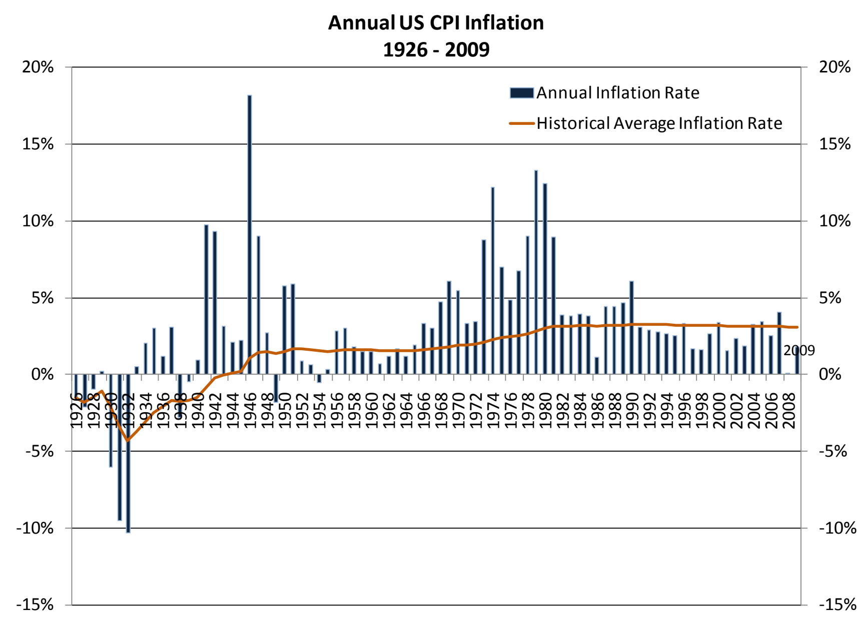
In US stocks, we've invested a larger proportion in active managers who focus on deep value stocks. We believe there are still significant opportunities to buy very solid companies at low prices. Our active large cap value manager has an excellent long-term record and was incidentally a runner up for Morningstar's 2009 manager of the year award.

Small cap stocks are also looking attractive as more and more indicators are showing signs of an economic recovery.

We continue to invest in emerging market stocks. While valuations have risen with recent strong performance, there is still a compelling argument to be made for emerging markets' growth versus developed markets. Further supporting emerging markets strength, is that fact that their fiscal situations are, by and large, significantly stronger than those of developed nations.

Inflation and What We're Doing about It
Inflation is often characterized as too many dollars chasing too few goods. We can display this in a simplified example. If you and a friend entered an empty room with $100 and one meal, what would that meal be worth? How about if you entered the room with $1 and 100 meals? In the first example the scarcity of goods (meals) and the relative abundance of money would make that meal worth about $100. In the second example, the relative scarcity of money and the relative abundance of meals would make each meal worth roughly a penny. This is approximately what happens in the real economy. If the money supply increases while the ability to produce goods and services is low, then the cost of those goods and services increases. This is inflation.

Chart 3 – Historical Inflation Rates



Source: Ibbotson Associates, Bureau of Labor Statistics, Stembrook Research.

What is happening today? We are currently in a situation where rising inflation is a potential, but not an immediate threat. Why? Although the Federal Reserve is giving banks the ability to increase the supply of dollars by making money cheap to lend, banks are not lending. With a lack of lending activity, the money supply is not increasing. However, when the pace of lending increases, the money supply could grow quite quickly and the Federal Reserve would need to quickly and accurately use its tools to reign in money supply growth. At the same time, our economy's ability to produce more goods and services is high. This is due to the fact that we have many plants and equipment on the sidelines while at the same time we have tremendous productive capacity in the form of unemployed workers. In order to see inflation, we need to see the money supply increase at a faster rate than we can increase production of goods and services.

Historically, large increases in money supply have led to higher inflation, but it will take time to see what will happen this time around.

How are we addressing this? The problem with managing risk is that once everyone can see it coming, hedging the risk will have already become very expensive. This is equivalent to asking for a quote on fire insurance for your house, *after* a fire has started. Therefore, we have taken a number of tacks to begin to protect against potentially higher inflation down the road.

Looking at financial theory and history, there are a few asset classes that help to hedge against inflation. If you simply want to maintain your purchasing power (i.e. you want a cup of coffee to be equally affordable to you in 20 years as it is today), then Treasury Bills are a good way to go. You won't get richer, and you won't get poorer. However, the world will probably get richer. A more elegant solution is to own Treasury Inflation Protected Securities or TIPS. TIPS are Government bonds that pay a "real" yield over and above observed inflation. For example, if observed inflation is 4 percent and the real yield on tips is 2 percent, the TIPS owner would realize a 6 percent annual return. A third option is to own commodities. Commodities are goods themselves, so you are effectively buying the very goods that will rise in price over time. Early last year, we took a diversified approach by combining these three strategies.

With TIPS up 13.5% since March 2009 versus 2.2% for nominal Treasury Bonds, TIPS have had a significant performance run of late. On a valuation basis, TIPS are priced fairly richly, today. For this reason, we are trimming exposure in taxable accounts and only adding new positions to tax-exempt portfolios, where these tax-inefficient securities are most efficiently invested. We will continue to monitor TIPS valuations and will add to them as and when their relative valuations improve.

Commodities behave a bit differently. While they tend to move up with inflation, they also tend to move in the same direction as economic growth. Commodities provide an inflation hedge, while being economically sensitive. But, as with most things, there is no free lunch. If economic activity declines further, commodities will likely do the same.

Thus far, both investments have added value to the portfolio on an absolute basis. TIPS have outperformed other low risk, fixed income asset classes, while commodities have significantly increased in value through the recovery. We hold these investments as risk management tools more than return maximization vehicles.

As for short-term bonds such as treasury bills, we have positioned our fixed income portfolio to have somewhat shorter maturities to protect against the risk of rising rates.

We will keep you posted on our evolving thoughts on this subject.

Investment Planning

At a time when many portfolios have experienced significant volatility, it is a good time to re-assess sustainable spending plans. This can have a positive influence not only on future investment returns, but also on the peace of mind that comes with having a well thought out plan in place.

As always, I welcome your questions and comments, and appreciate your continued confidence.

Peter D. D'Agati, CFA
President
Stembrook Asset Management, LLC
83 Wayne Street, Suite 101
Jersey City, NJ 07302
Tel: 201-484-0063
Fax: 201-484-0070
peter.dagati@stembrook.com

[i] Based on the DALBAR, Inc. Quantitative Analysis of Investor Behavior (QAIB), 2009 study. This study compares returns of average investors verses market indexes from 1989 to 2008. For the 20 years ended 12/31/08 the equity market as measured by the S&P500 index has returned 6.48% while the average equity investor has returned 1.87%. Over the same period, the average fixed income investor as measured by the Barclays Aggregate bond index has returned 6.66% while the average fixed income investor has returned 0.77%.

The QAIB uses data from the Investment Company Institute, Standard and Poors and Barclays Capital Index Products to compare mutual fund investor behavior with an appropriate set of benchmarks. Covering the period from January 1, 1989, through December 31, 2008, the study utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. The behaviors are then used to simulate the "average investor." Based on this behavior, the analysis calculates "average investor return" on both a cumulative and annualized basis. These results are compared to respective indices.