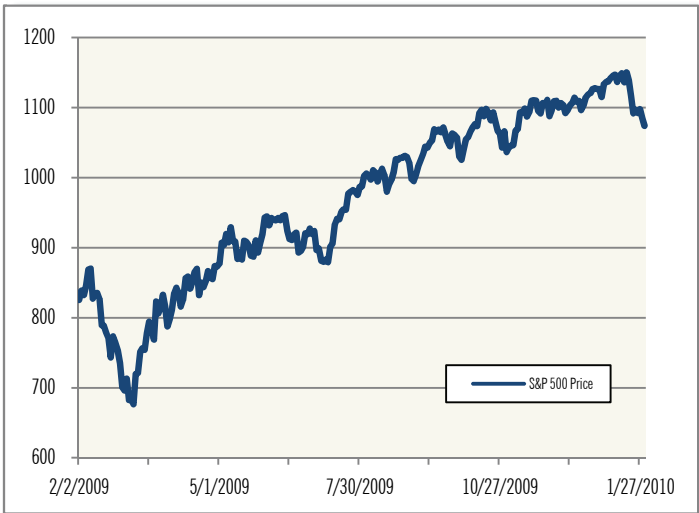


**S&P 500 PRICE**



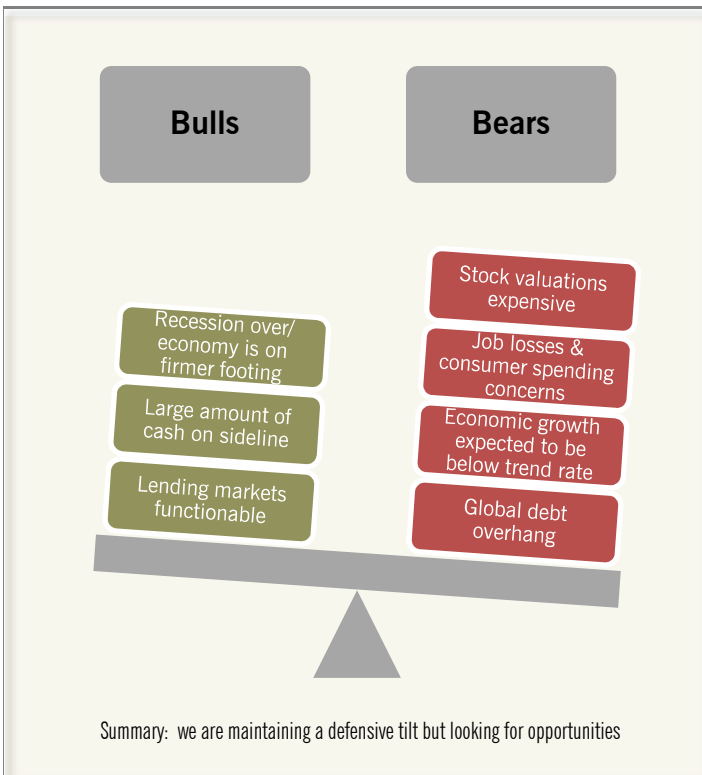
The S&P 500 index posted only its second monthly loss since February of last year as strong domestic economic growth and corporate earnings reports were overshadowed by investor fretting about the prospects of a potential slowdown in the Chinese economy (thanks to a reining in of credit) and sovereign credit default worries in countries such as Greece. The stock index finished nearly 7% below intramonth highs, not quite at correction levels.

**NOTES/COMMENTARY**

With the recession considered to be over, a key focus for many investors has turned to the shape of the recovery. Even as it was reported that the U.S. economy grew at a 5.7% rate in Q4, the fastest pace in more than six years, some pointed out that it was meager compared with prior recoveries and buoyed mostly by a declining rate of inventory reductions. Many expect growth to slow quite markedly, as consumer spending alone will not be able to drive continued robust expansion absent an inventory boost or the benefit of government stimulus programs. Still, prognosticators have come up with a virtual alphabet soup of projections, including the double-dip “W”-shaped recovery, the “L” in which the economy bounces along the bottom for some period, the slow growth “U”, and the robust “V”.

In our opinion, absent a global shock it feels as if the extreme negative scenarios (i.e. depression) are less likely than previously considered. In fact, many of our managers are feeling more comfortable with the outlook for high quality companies with strong balance sheets that they are able to acquire at attractive valuations. Nevertheless, if we consider return prospects in general to be still somewhat compressed given what is already priced into many segments of the market, then being higher in the capital stack and receiving a greater current yield while waiting things out seems to make sense. This translates into a continuation of our recommendation to overweight credit relative to equities and alpha-generating strategies (i.e. long/short) relative to high market beta.

**SUMMARY OF CURRENT EQUITY MARKET LEANINGS**

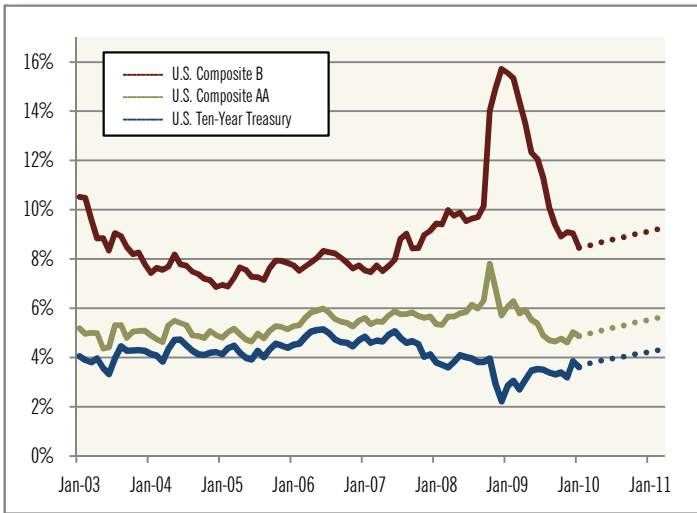


**CONVERGENT TACTICAL POSITIONING**

<b>Equity</b>		
US Large Cap Equity	underweight	
US Small/Mid Cap Eq.	slight underweight	
Developed Non-U.S. Eq.	underweight	
Emerging Markets Eq.	slight underweight	
Private Equity	neutral	
Directional Hedge Funds	underweight	
<b>Real Assets</b>		
Real Estate	neutral	
Commodities	overweight	
<b>Arbitrage/Credit</b>		
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
<b>Fixed Income</b>		
Core Fixed Income	slight overweight	
Cash Equivalents	overweight	

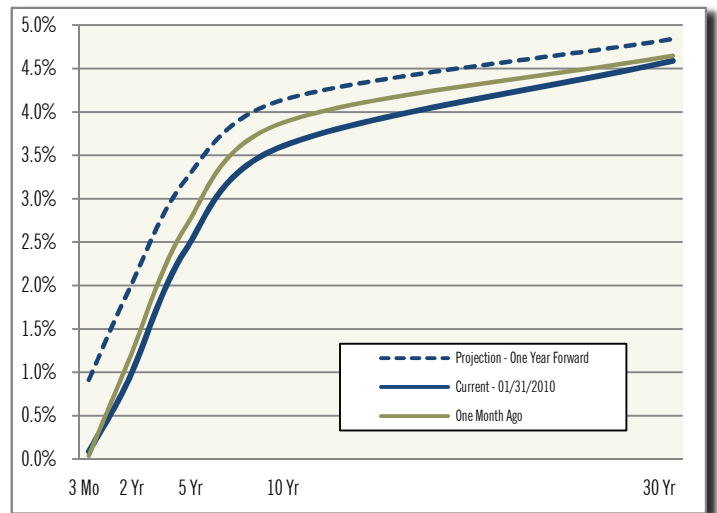
Given the wide level of uncertainty about economic outcomes (including the shape of the recovery, sovereign credit risk, inflation/deflation, and the longer-term direction of the dollar), we are keeping in place shifts to overweight certain segments of the opportunistic credit market, core fixed income/cash and real assets (gold in particular). Equities, which may still be a bit extended in terms of valuations, remain underweight in our models.

**CREDIT YIELD SPREADS**



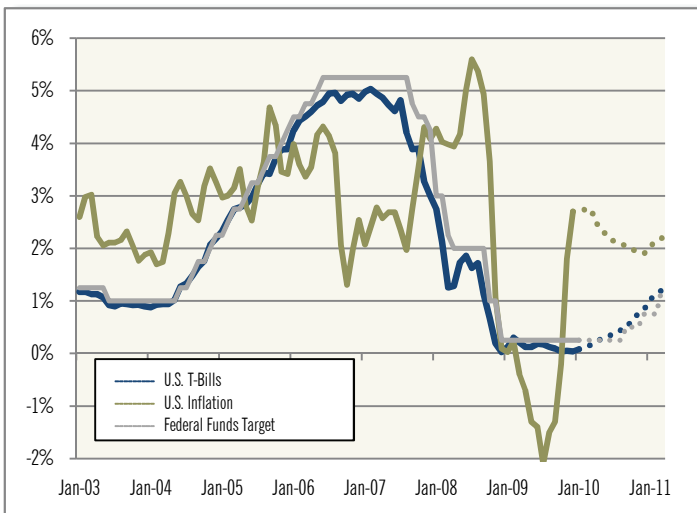
High yield corporate credit yields and spreads continue to contract and are now near average historical levels. As such, returns in the high yield space going forward are expected to be much more moderate than the record 2009 gains, and could suffer if default expectations increase and spreads widen or if yields rise concomitantly with any increase in government yields. The consensus, however, calls for a continued modest rise in yields of Treasuries/corporate debt in conjunction with sluggish growth/low inflation expectations. **Advantage: Neutral**

**U.S. TREASURY YIELD CURVE**



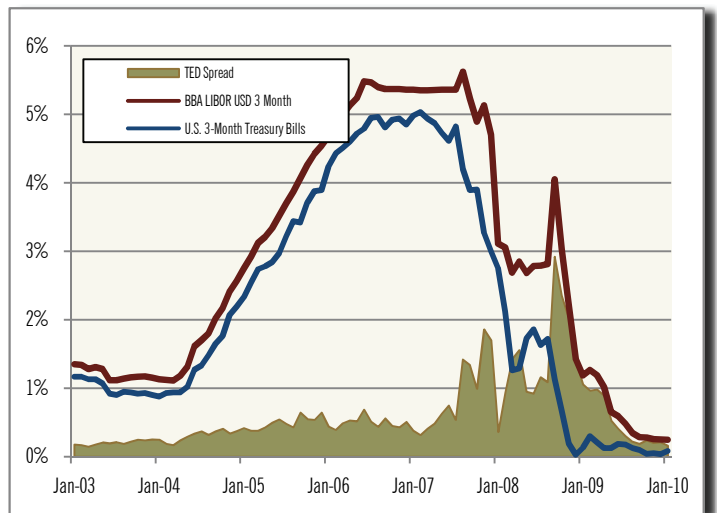
With the Fed committed to keeping interest rates "exceptionally low" for some time to help sustain recent growth, the Treasury yield curve is expected to remain mostly rangebound despite supply issues and the ending of quantitative easing programs. The Fed, of course, may modify the plan to end those stimulus programs if necessary. **Advantage: Neutral**

**T-BILLS, FEDERAL FUNDS AND INFLATION**



The Fed is expected to remain on hold at least through the first half of this year for fear of stalling the economic recovery and as inflation expectations are constrained. Disinflation is expected to continue in the short-term; longer-term, there is the fear that inflation could rapidly and unexpectedly spike much higher. **Advantage: Neutral**

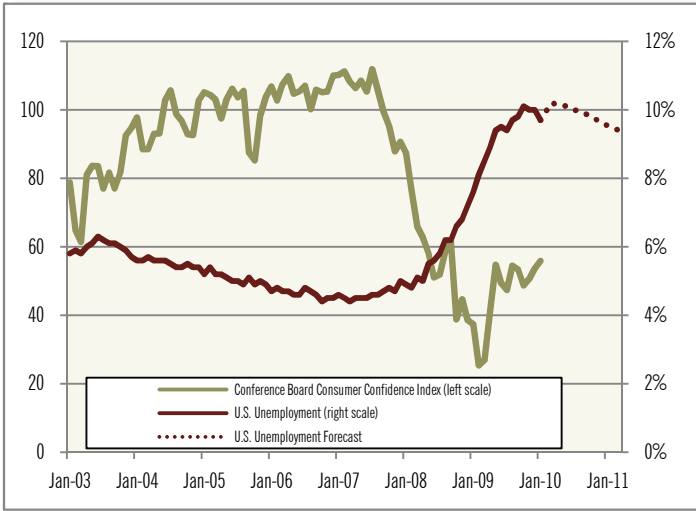
**LIBOR/T-BILL RATES AND TED SPREAD**



The TED spread is a measure of how tight the credit markets are as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). During last year's credit crisis, extremely wide TED spreads indicated a high degree of anxiety and riskiness in the bank lending market as liquidity was being withdrawn. The subsequent decline (to lower levels than before the crisis began) illustrates that the functionality of credit markets has improved markedly. **Advantage: Bulls**

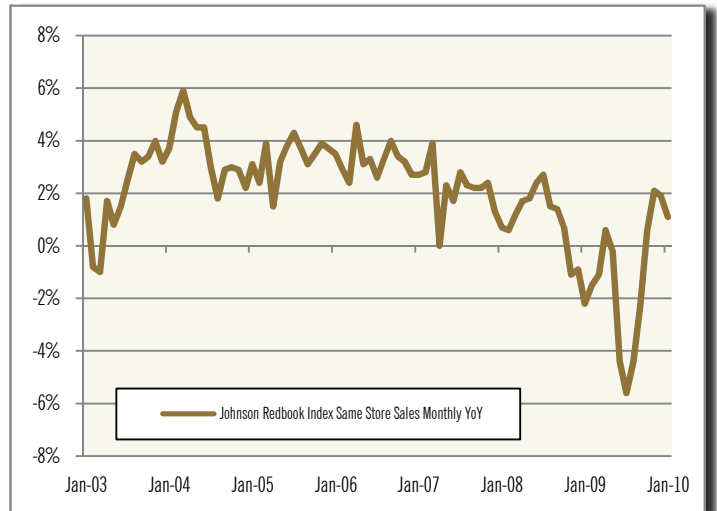
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

**CONSUMER CONFIDENCE & UNEMPLOYMENT**



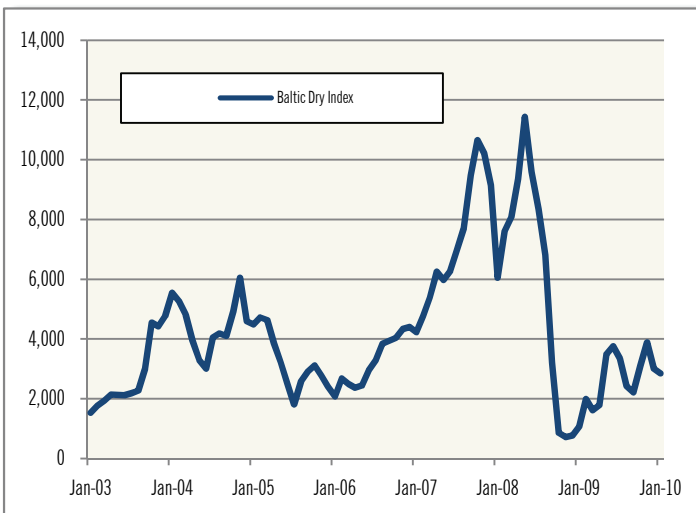
The U.S. labor market remains weak, despite an unexpected decline in the unemployment rate to below 10% in January. Worries about job losses have kept consumer confidence weak, and far below levels that signify a solid economy. As consumer spending accounts for about 2/3 of economic activity, fears are that restrained spending will hamper the recovery. The Fed will likely be watching labor markets closely in determining when to raise interest rates. **Advantage: Bears**

**RETAIL SALES**



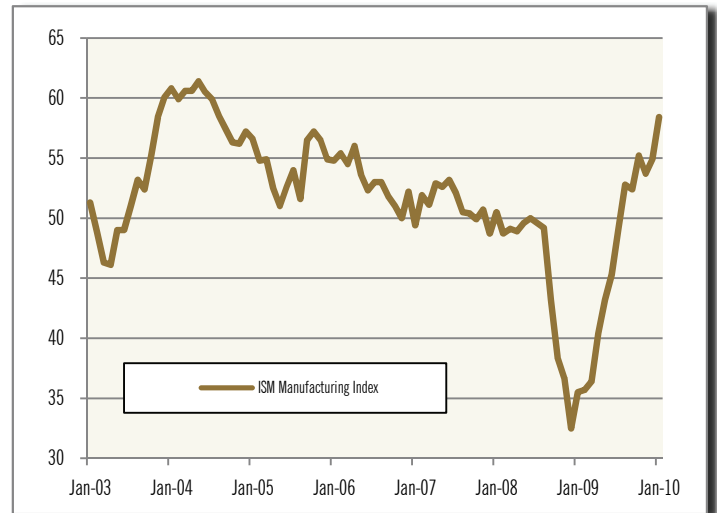
Retail sales figures, which track the dollar value of merchandise sold to consumers, could be an indicator of economic recovery and ultimately inflationary pressures. Recent data has been mixed; some reports indicate that consumers are feeling a bit better about their personal financial situations, but most are still cutting back on spending. January is generally a transitional month with clearance and inventory reshaping. **Advantage: Neutral**

**BALTIC DRY INDEX**



The Baltic Dry Index (BDI), a measure of world trade, provides a barometer of the shipping costs for commodities. The BDI fell in January, led by a slump in iron ore carrier rentals. Still, the index is well off the lows seen a year ago as the status of the global economy has improved. **Advantage: Neutral**

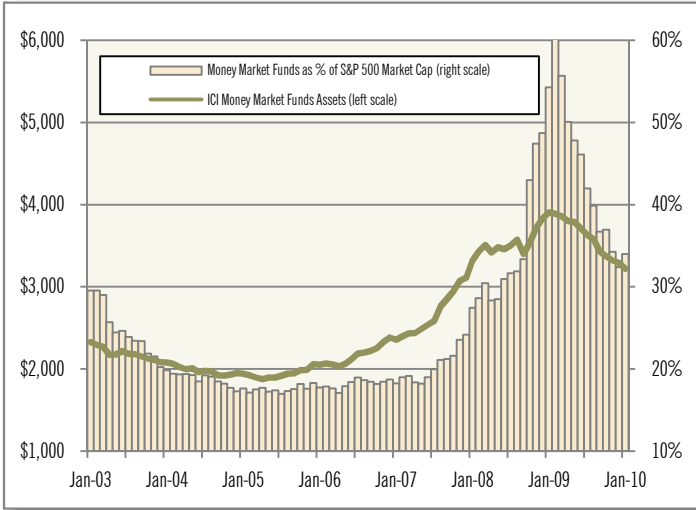
**ISM MANUFACTURING INDEX**



The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, delivery times, prices, export orders and import orders. The index has been one of the better predictors of the business cycle over the years; a reading over 50% indicates expansion relative to the prior month, while a sub-50% reading indicates contraction. In January, the index soared to its highest level since August 2004. **Advantage: Bulls**

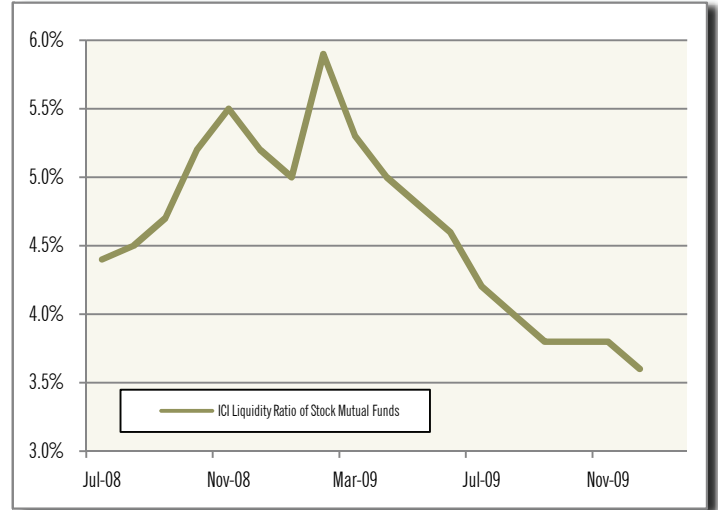
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MONEY MARKET FUNDS ASSETS (\$ BILLIONS)



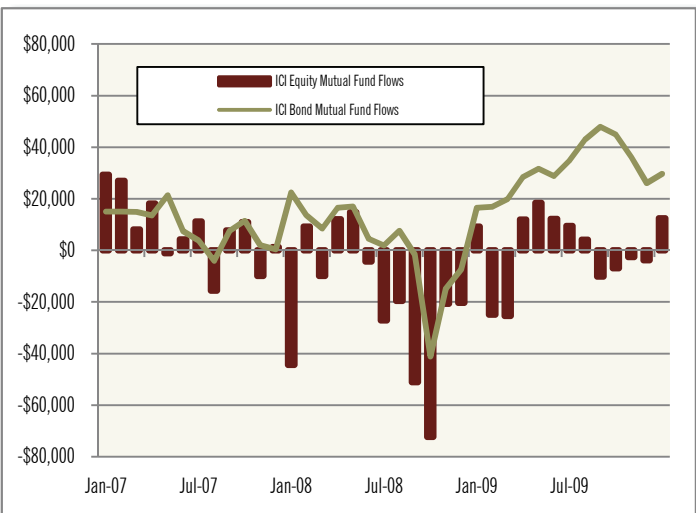
Some of the cash balance built up over the past few years has been put to work, but there still remains a large amount on the sidelines. Unless investors have decided to dramatically increase their savings rate (and there is possibility of that we are experiencing a secular shift towards increased savings and higher bond allocations) there remains plenty of powder available for stocks, at least from retail investors. Many managers, however, have already reduced their cash balances in an attempt to keep up with the market. **Advantage: Bulls**

MUTUAL FUND LIQUIDITY RATIO



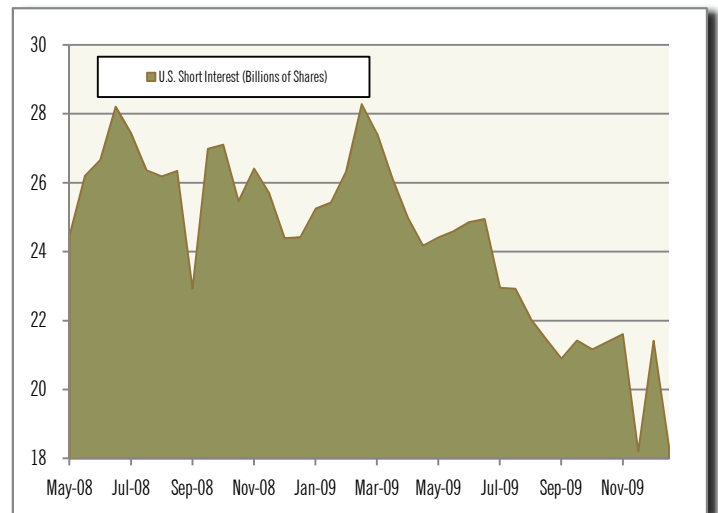
The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As the stock market tanked in early 2009, mutual fund managers were bearish and sitting on a historically large amount of cash. In the ensuing rally, however, managers have put most of that to work and are now holding unusually low levels of dry powder. If retail investors continue to shy away from equities and portfolio managers are near fully invested, where will the next leg of buying power come from? **Advantage: Bears**

MUTUAL FUND CASH FLOWS (\$ MILLIONS)



Dollars continue to head into bond funds while equity mutual funds see little inflows. Is this evidence of a secular shift in investor behavior? Perhaps, or maybe retail investor activities are simply a good contrary indicator. Whether (and when) retail investors jump back into equities remains to be seen. **Advantage: Neutral**

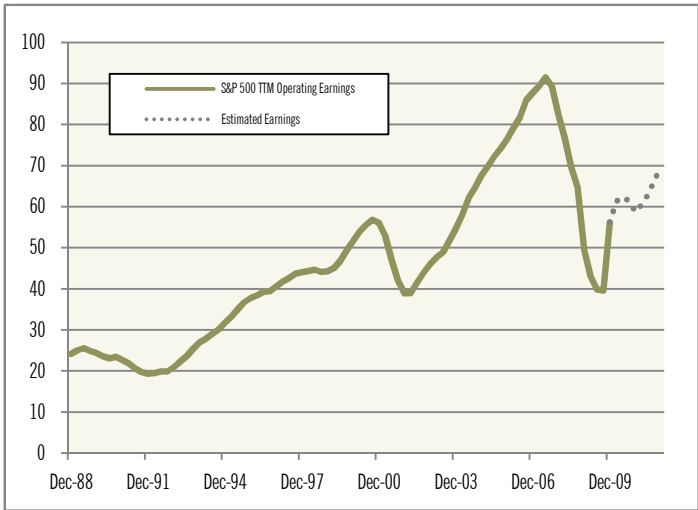
U.S. SHORT INTEREST



Short interest (the number of shares sold short but not yet covered) can be a telling indicator of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices. Short covering has been heavy since the market lows in early 2009, and perhaps a significant contributor to stock gains. As short interest has declined, the benefits from any short squeeze are probably behind us. **Advantage: Bears**

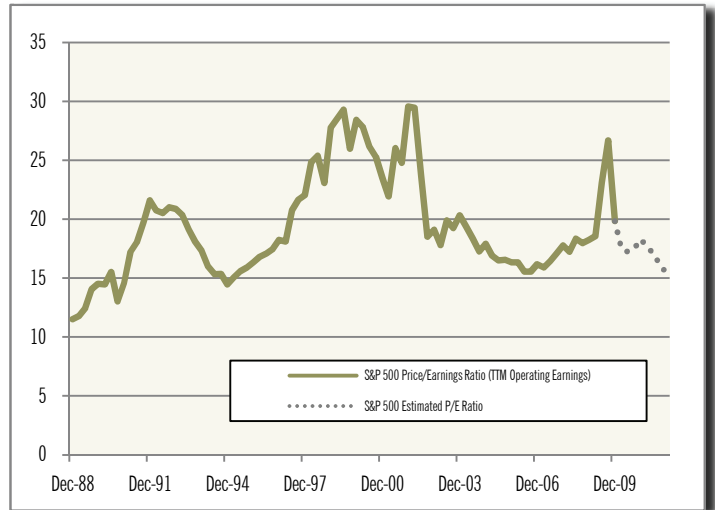
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CORPORATE EARNINGS



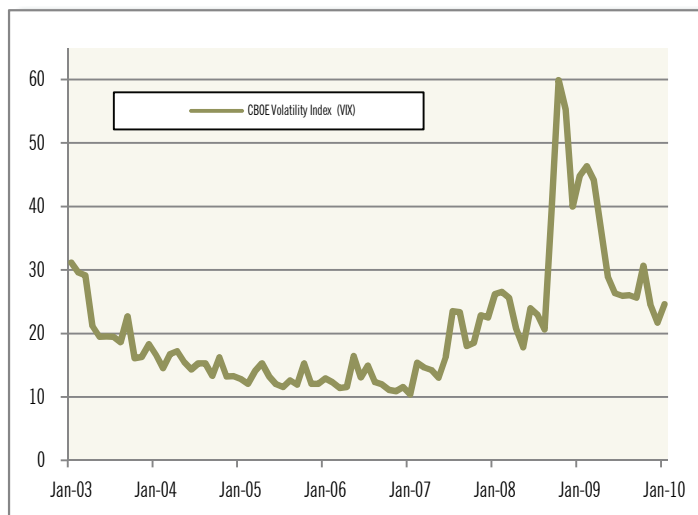
Q4 earnings news continues to look strong, with about 78% of companies beating estimates. Top-line growth is still slow, however, and future growth in sales depends on jobs and consumer spending. As such, forward guidance coming out of companies is not quite as rosy. Comparisons with year-ago statistics are also a bit sketchy, given index membership changes and proforma adjustments. Nevertheless, it is apparent the mood towards corporate earnings has improved dramatically. **Advantage: Neutral**

STOCK MARKET VALUATIONS



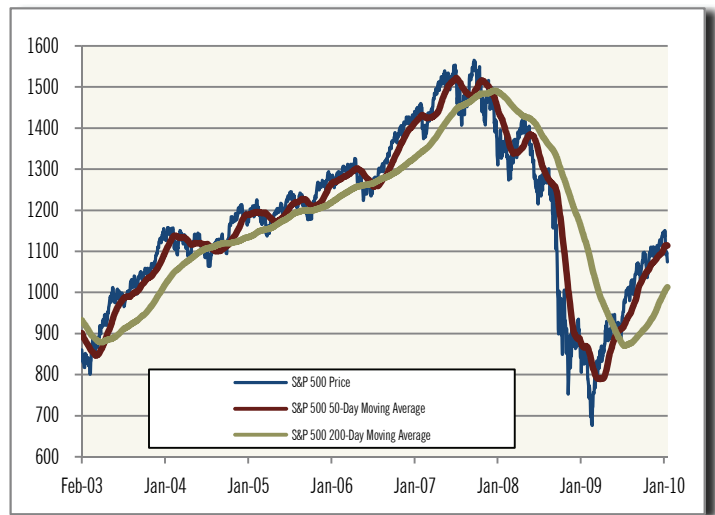
Despite an improvement as Q4 earnings have been recorded, valuations are still relatively expensive by almost any measure, whether based on forward, trailing, operating, as reported or smoothed earnings. The S&P 500 currently trades at about 20x trailing 12-month operating earnings, a level that is not conducive to attractive longer-term returns. In order for valuations to become more attractive, revenue growth needs to continue to show improvement and catch up with high expectations or prices need to fall (or a combination thereof). **Advantage: Bears**

STOCK MARKET VOLATILITY



Volatility (as measured by the Chicago Board Options Exchange Volatility Index) bounced around in January, hitting a 12-month low of 17.5 before rebounding as stock prices slid to end the month at 24.6. Bears argue that a low VIX could be a sign of complacency, while bulls point out that it allows investors to remain more confident and fully invested as the cost of hedging has become cheaper. **Advantage: Neutral**

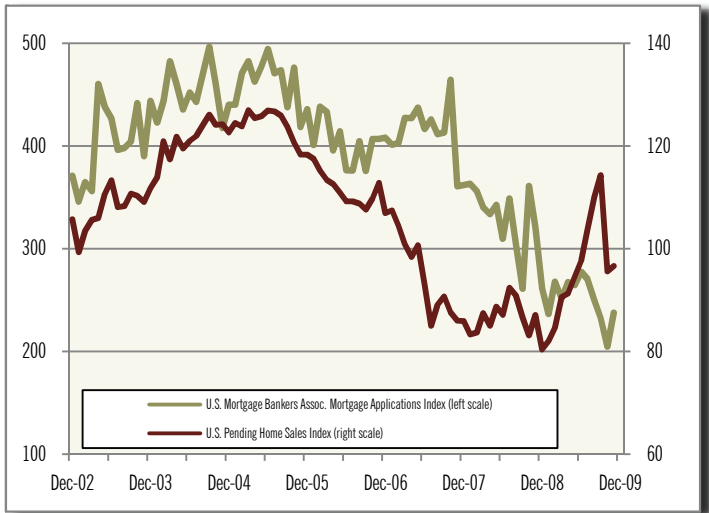
STOCK MARKET TECHNICALS



Several technical indicators continue to be supportive of the equity market. The 50-day moving average of the S&P 500 is higher than the 200-day moving average, interpreted by many as a bullish signal. **Advantage: Bulls**

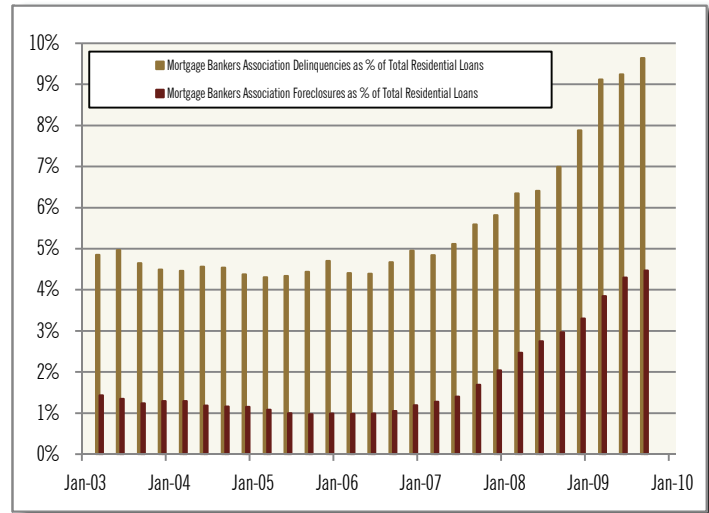
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MORTGAGE APPLICATIONS & PENDING HOME SALES



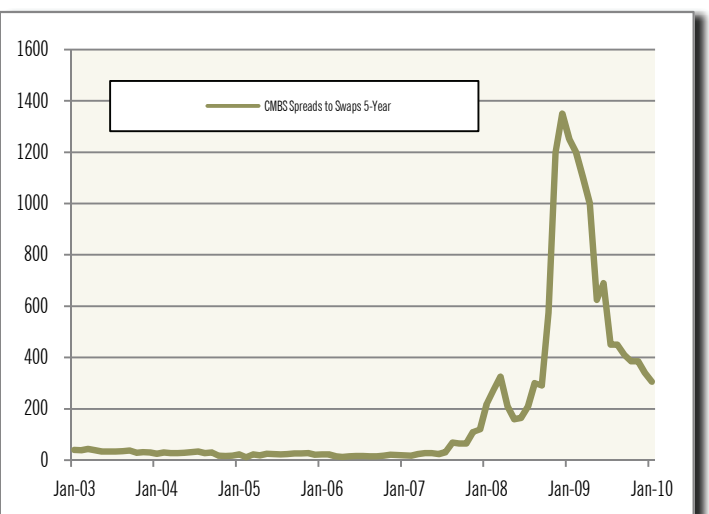
Most feel that the recent spike and ensuing drop in home sales figures were driven largely by the anticipated expiration of the first-time homebuyer tax credit program, which was subsequently extended and expanded. Even as pending home sales had been rising, mortgage applications have been trending downward perhaps indicative of waning stimulus or constrained credit markets. While any improvements in the housing markets are welcome, high unemployment and a large amount of supply is likely to dampen any gains. **Advantage: Bears**

RESIDENTIAL DELINQUENCIES & DEFAULTS



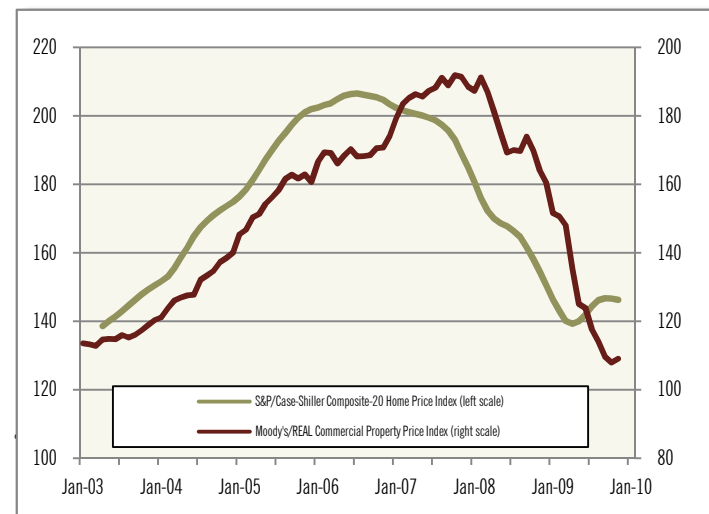
Mortgage delinquencies and foreclosures continue to surge. With high unemployment, the wave of foreclosures is not expected to crest until sometime later this year, and will be a headwind to the housing market and economy for some time. **Advantage: Bears**

CMBS SPREADS



Despite a significant pullback in CMBS spreads since the peak of the credit crisis, levels are still high in a historical context as concerns remain about commercial real estate loans. Even though banks are mostly unwilling to force foreclosures and would rather amend existing loan provisions, loss expectations are high in part due to the huge amount of debt that needs to be rolled over in the next few years at the same time that unemployment is high, vacancies are rising and rental rates are falling. **Advantage: Bears**

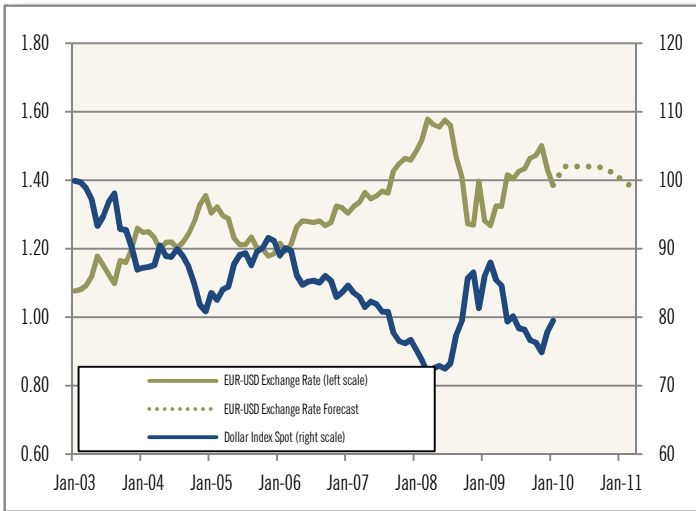
RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES



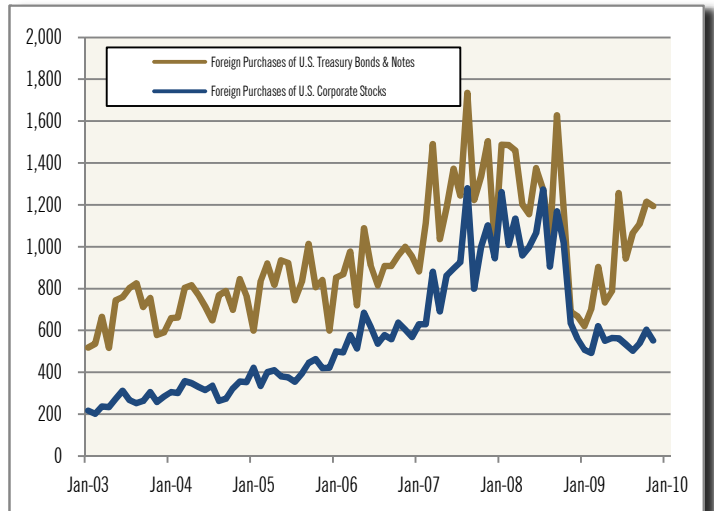
Both residential and commercial real estate prices have experienced a dramatic pullback from levels seen a few years ago and are now hovering at or below values last seen back in 2003. While residential prices may be stabilizing (at least for the time being), the decline in home prices means that many mortgage holders now owe more than their homes are worth. Recovery in commercial price index levels, meanwhile, may be closely tied to future job growth and will likely be slow. A renewed downtrend in property prices, given the amount of debt outstanding, could spell trouble for the banks and the economy. **Advantage: Neutral**

Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. DOLLAR



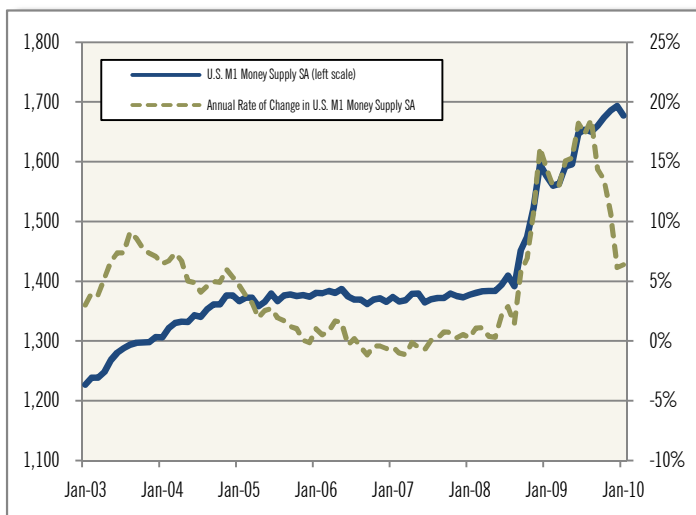
FOREIGN PURCHASES OF U.S. SECURITIES (\$ BILLIONS)



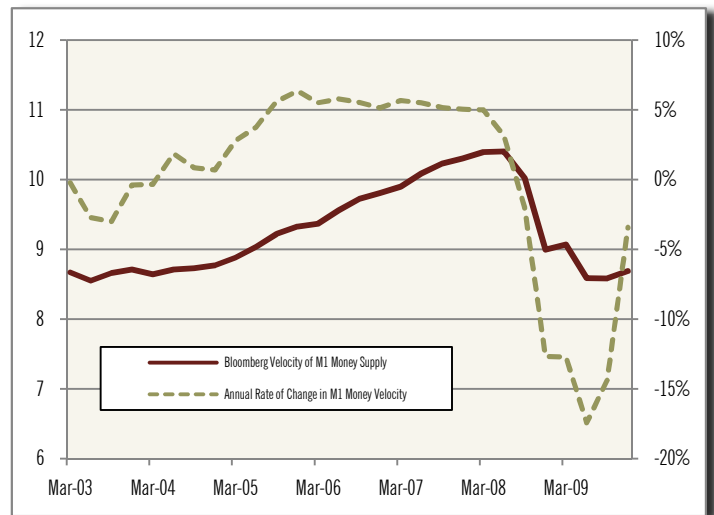
The U.S. dollar continued to rally in January, reflecting concerns about credit deterioration overseas in countries such as Greece, Spain and Portugal. The Euro is under particular pressure. While short-term flights-to-quality are not unexpected, most still consider the dollar to be in a secular decline as it faces longer-term issues such as the size of the U.S. budget deficit. The dollar may be further hampered by expectations of continued low domestic interest rate policies while other countries are already raising rates. **Advantage: Neutral**

Foreign purchases of U.S. stocks remains constrained, though Treasury securities are still in demand from the global constituency. Going forward, a concern is that dollar worries may keep some foreign investors away. In the long-run, a lack of demand for American investments is not helpful to U.S. market returns. For now, at least, things appear to have stabilized. **Advantage: Neutral**

U.S. M1 MONEY SUPPLY



VELOCITY OF M1 MONEY SUPPLY



M1, the most narrowly defined measure of how much money is in circulation, consists of the most liquid forms of money, namely currency and checkable deposits. With the Fed-initiated programs of fiscal and monetary stimulus to unlock credit and revive the economy, M1 has spiked to unprecedented levels, causing fears of what some consider inevitable inflation and dollar weakness. **Advantage: Neutral**

Velocity of money measures the rate at which money changes hands in order to purchase goods and services. While the money supply has surged, velocity has actually dropped significantly as consumers and businesses are unwilling to spend money in a difficult environment or are not able to take advantage of lending programs. **Advantage: Neutral**

Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

ECONOMIC/MACRO THEMES

Listed below are several economic/macro themes that we are currently considering as we evaluate our tactical portfolio positioning. Several of these themes, and the manner of addressing them, overlap. When evaluating these risks/opportunities, we consider both if there are practical manners of addressing them that are accretive to the total portfolio (on a relative and risk-adjusted basis) as well as potential outcomes if these themes do not come to fruition (i.e. what if we are wrong).

RISKS

- **Low reward/high risk environment** – more specifically, the concern that the recent equity market advance has possibly been a cyclical bull rally within a secular bear market, and that at the least a variety of asset classes have unsound fundamentals and rich valuations and are susceptible to a meaningful pullback.

*Risk Horizon:* Near-term                      *Probability:* High                      *Portfolio Threat:* High

*Portfolio Impact:* Losses in growth assets, including equities, real estate, commodities, high yield

*To Mitigate:* Decrease exposure to long-only assets that are potentially overvalued in favor of cash or other investments that are less sensitive to market beta; for risk assets, increase usage of long/short managers; increase usage of fundamentally-driven and high quality equity strategies (though not necessarily fully removing our preference for low fee, tax efficient large cap exposure)

*Cost of Being Wrong:* Not necessarily high, as we are only recommending a decrease in exposure to growth assets and not a full elimination. A portion of any further rally might be missed, but the bulk of any upside can still be captured

- **Deflation** – if economic growth stagnates and a double dip recession is experienced, there is the possibility of falling into a deflationary spiral as the Fed is potentially limited in additional options to stimulate pricing levels. Disinflation (the current environment) is not the concern, but rather an extended period of deep decline in prices of all assets.

*Risk Horizon:* Near-term                      *Probability:* Moderate                      *Portfolio Threat:* High

*Portfolio Impact:* Losses and/or underperformance in equities and growth assets

*To Mitigate:* Maintain core fixed income (including Treasuries) and cash positions; increase allocation to gold

*Cost of Being Wrong:* If inflation and yields spike, Treasury losses could be significant, so diversify bond exposure and do not go out too far in maturity

- **Inflation** – while deflation is a portfolio concern in the near-term, looking out longer-term there are risks that inflation could spike due to the huge monetary stimulus or in response to a debasement of the dollar. This could occur with or without strong economic growth (i.e. stagflation). Regardless, interest rates will likely rise if inflation fears materialize.

*Risk Horizon:* Intermediate to long-term                      *Probability:* Moderate to High                      *Portfolio Threat:* Moderate

*Portfolio Impact:* Losses in core bonds; underperformance in equities

*To Mitigate:* Increase exposure to real assets (including commodities/gold) and commodity currencies; shorten core fixed income duration; consider reducing fixed income allocations (but not yet given near-term deflation concerns)

*Cost of Being Wrong:* Real assets have various drivers of return and belong in a portfolio beyond being viewed as simply an inflation hedge, but commodities can be very volatile so do not warrant huge overweights. Given low yields, shortening bond portfolio duration should come at a modest opportunity cost

- **Rising interest rates** – interest rates, which are currently near historical lows, could rise significantly for a number of reasons including strong economic growth, inflation fears, U.S. dollar weakness, supply issues or reduced foreign demand. The Fed is committed to keeping a policy of low rates for the time being, however, so no immediate action may be necessary.

*Risk Horizon:* Intermediate to long-term                      *Probability:* High                      *Portfolio Threat:* Moderate

*Portfolio Impact:* Losses in core bonds (especially longer duration Treasuries)

*To Mitigate:* Reduce bond portfolio duration; diversify core fixed income exposure; consider reducing allocation to core fixed income; shift to cash

*Cost of Being Wrong:* Even with a steep yield curve, given low absolute yield levels the opportunity cost of overweighting cash/ultra-short credit is minimal. Given that yields are near zero for money market instruments, however, this is not a viable long-term strategy. If reducing bond allocations, the question is where to go? Shifting into riskier assets does not make sense currently

Other areas of portfolio risk that we are evaluating include (i) a secular shift towards savings and increased fixed income allocations (driven in part by evolving demographics); (ii) slower economic growth in the developed economies of U.S./Europe driven in part due to structural reductions in consumer consumption/spending (in conjunction with faster growth in developing economies), (iii) the ongoing debt overhang (and concomitant sovereign risk and U.S. bank risk); (iv) geopolitical shocks (war, terrorism); and (v) changes in U.S. tax legislation.

ECONOMIC/MACRO THEMES

OPPORTUNITIES

- **Shortage of natural resources** – the emergence of the middle class in economies such as China, India, and Latin/South America (demographic groups that currently do not have much in the way of debt) could put a strain on natural resources, leading to a continued secular uptrend in commodity prices.

*Horizon: Long-term Probability: Moderate Opportunity Level: Moderate/High*

*To take Advantage: Increase allocation to diversified commodities, emerging market equities and commodity currencies*

*Cost of Being Wrong: Underperformance versus developed equities/bonds. Commodities and emerging market currencies are also volatile and most suitable for investors with a long investment horizon not impacted by current spending needs.*

- **U.S. dollar weakness** -- there are fundamental reasons (such as U.S. budget deficits) for the dollar, which has lost some appeal as a safe haven, to continue its long-term secular downtrend. Short-term rallies on flight-to-quality movements or as carry trades are unwound could be expected, however, and forecasting currencies is treacherous. Of course, a significant and rapid drop in the dollar could lead to inflation and rising interest rates, both of which pose risks to a portfolio.

*Horizon: Near to long-term Probability: Moderate Opportunity Level: Moderate*

*To take Advantage: For U.S.-based investors: increase allocation to commodities (including gold); increase exposure to emerging market debt/currencies; increase exposure to international equities and bonds*

*Cost of Being Wrong: Underperformance of international versus U.S. securities. There are other reasons (expected growth rates, market cap/GDP), however, that warrant increased foreign exposure. With regards to commodities, long-term real assets returns are not dependent upon currency movements. Emerging market currencies could be volatile, so warrant only modest portfolio allocations.*

Other opportunities we are exploring include: (i) the longer-term distressed cycle; (ii) repricing of illiquidity (i.e. private real estate/equities being potentially more attractively priced than public equities); (iii) long-term - more rapid economic growth in developing economies (in contrast with slower growth in developed nations); and (iv) a focus on alpha-generating strategies, including long/short versus high market beta, fundamental equity strategies (a greater differentiation between high quality and low quality companies) and high dividend paying strategies.

ASSET CLASS COMMENTARY

ASSET CLASS	TACTICAL POSITIONING	THEME	ASSET CLASS NOTES/OBSERVATIONS
<b>Equity</b>	<b>underweight</b>		<b>- a conservative allocation to equities in the current environment is warranted</b>
US Large Cap Equity	underweight	<b>Low reward/high risk environment.</b>  Positioning: underweight equities, particularly long-only, while overweighting long/short and focusing on fundamentals	- given economic and forward earnings uncertainty, along with expensive valuations, there is a high level of downside risk associated with stocks and an underweight allocation (but not elimination) is recommended - for most taxable clients a passive (low tax, low fee) approach is still recommended as the core - active mgmt focusing on fundamentals (high quality/high dividend) could provide some downside protection
US Small/Mid Cap Equity	slight underweight		- our already low levels of small cap exposure make further reductions not meaningful - we generally have an overweight tilt to small (and value) relative to large - all cap managers, with their increased allocation flexibility, may be able to better position portfolios
Developed Intl Equity	underweight		- a recommended reduction but generally less so than domestic - resulting overweight to international relative to U.S. provides some protection against secular dollar decline - valuations in many international regions are more attractive than that of the U.S.
Emerging Market Equity	slight underweight		- strong long-term economic growth prospects, potentially much greater so than in the developed regions - current valuations are difficult to decipher (i.e. China) and a high level of volatility is expected - as we deem it is appropriate to shift back into risk (growth) assets, we anticipate overweighting developing mkt
Private Equity	neutral		- good opportunity set (with better pricing than public markets), but managers have existing portfolio distractions
Directional Hedge Funds	underweight		- though reduced, L/S allocations are significantly overweight relative to long-only equity allocations - better anticipated protection against equity downturn but may lag in rallies (barring superior stock selection) - managers are seeing correlations among stocks decrease (and dispersions in returns increase)... superior selection matters
<b>Real Assets</b>	<b>overweight</b>		<b>- increased allocation as currency/inflation hedge and longer-term play on natural resource shortage</b>
Real Estate	neutral	<b>Inflation; U.S. dollar weakness; shortage of natural resources.</b>  Positioning: overweight (gold in particular)	- commercial real estate refinancing issues remain, but values abound for those private managers with capital - REITs are not necessarily cheap, but becoming clearly divided between thrivers and merely-survivors
Commodities	overweight		- recommend gold exposure for safe haven, weak dollar and inflation posturing - central bank buying of gold, combined with stagnant production = bullish demand/supply attributes - diversified commodity exposure a non-equity manner of playing the emerging market economic growth story
<b>Arbitrage/Credit</b>	<b>overweight</b>		<b>- low hanging fruit (beta) is probably played out, but pockets of opportunities remain</b>
Multi-Strategy Hedge Funds	neutral	<b>Low reward/high risk environment; inflation; U.S. dollar weakness; rise in interest rates</b>  Positioning: overweight	- superior security selection (both long and particularly short) could be a significant value-add - corporate defaults expected to be an issue for several years, providing potential opportunities - redemption, liquidity and restructuring issues are much less of a distraction
Opportunistic Credit	overweight		- as spreads have narrowed, high yield corporate debt/bank debt beta opportunity has waned - emerging market debt could provide a currency/inflation hedge - investment grade global bond exposure seeks to provide diversification
<b>Fixed Income</b>	<b>overweight</b>		<b>- increased allocation while waiting to deploy back into overpriced growth assets</b>
Core Fixed Income	slight overweight	<b>Low reward/high risk environment; deflation</b>  Positioning: Overweight for risk management purposes.	- in the near-term, Treasury/munis may be beneficial as deflation plays out - despite supply issues, demand remains strong from both retail and foreign investors - given low yields, long-term prospects are muted... inflation and rising rates may end the bull market in credit
Cash Equivalents	overweight		- low bond yields relative to cash makes holding dry powder in cash or short-term instruments sensible

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