

Commentary

Stock markets ended the year strongly, and 2010, like 2009, will go into the books as an excellent year for most asset classes (at least once the bumpy ride has been forgotten). As for the first full decade of the 21st century, that might be another story and one that many stock investors would like to forget. The S&P 500 began the decade at a price level of 1320 and, after experiencing two bear market collapses, ended at 1258. Taking dividends into consideration, the ten-year annualized return for U.S. large cap equities was a measly 1.4%, marking one of the worst decades in history (rivaling the 1930s, which included the Great Depression).

Many pundits have taken to calling the recent timeframe the "lost decade" for stocks. This fails to take into consideration that many (if not most) other asset classes actually posted decent total returns over the past ten years, especially those that did not start out at bubble levels. Emerging market equities led the way, gaining over 16% annualized, while developed international stock markets rose nearly 4% and domestic small cap was up over 6%. REITs and commodities didn't do too badly (11% and 6%, respectively), while taxable bonds did fine with total returns in the neighborhood of 6%. The bottom line: diversification over longer time frames can be very beneficial, even if there are temporary breakdowns when all asset classes seem to move in tandem. As for the next decade, good market periods often follow poor ones, especially when starting out on better footing from a valuation standpoint. While that is no guarantee of strong returns, investors should not hold an aversion to stocks based simply on the pain of the past decade.

CONVERGENT TACTICAL POSITIONING

Given an intermediate-term increasing risk in the ability of bonds to preserve purchasing power, we are underweight our strategic core fixed income target. This risk comes both in the case of rates staying at historically low levels or if prices are hurt by a further rise in yields. The underweight, along with a slight reduction to equities, accommodates our shift to opportunistic credit segments (such as multi-sector, emerging market currencies/debt, and international bonds) where we can collect a current yield while addressing inflation, currency, and U.S. interest rate risks. Within the real assets bucket, we remain underweight REITs and pooled commodities in favor of gold, which serves as a paper currency hedge and safe-haven asset.

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EQUITY	slight underweight	
U.S. Equity	neutral	
Developed Non-U.S.	underweight	
Emerging Markets	overweight	
Private Equity	neutral	
Directional Hedge	slight underweight	
REAL ASSETS	slight underweight	
Real Estate	underweight	
Commodities	overweight	
ARBITRAGE/CREDIT	overweight	
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
CORE FIXED INCOME	underweight	
Core Fixed Income	underweight	
Cash Equivalents	overweight	

THE EQUITY AND FIXED INCOME MARKETS

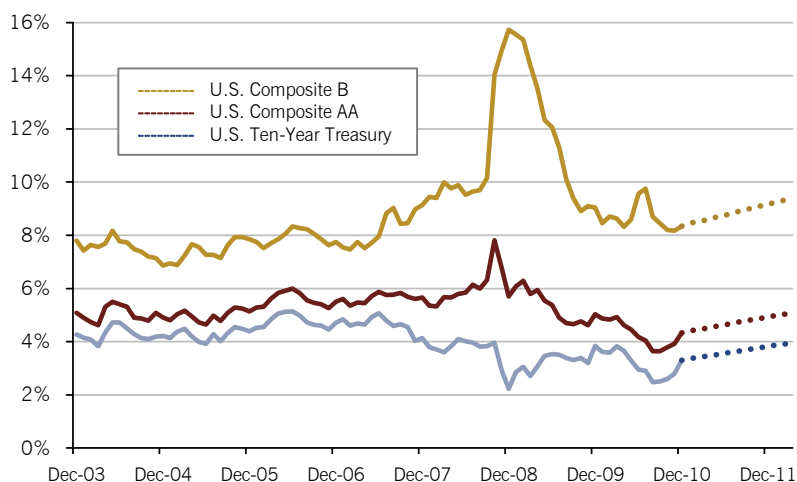
S&P 500 PRICE

Stocks ended the year on a high note, with the S&P 500 gaining nearly 7% in the month of December to close near a two-year high. For 2010, the index finished up 15%. In price terms, the benchmark has risen 86% off its March 2009 low and is now less than 20% below its all time high of 1565 reached in October 2007.



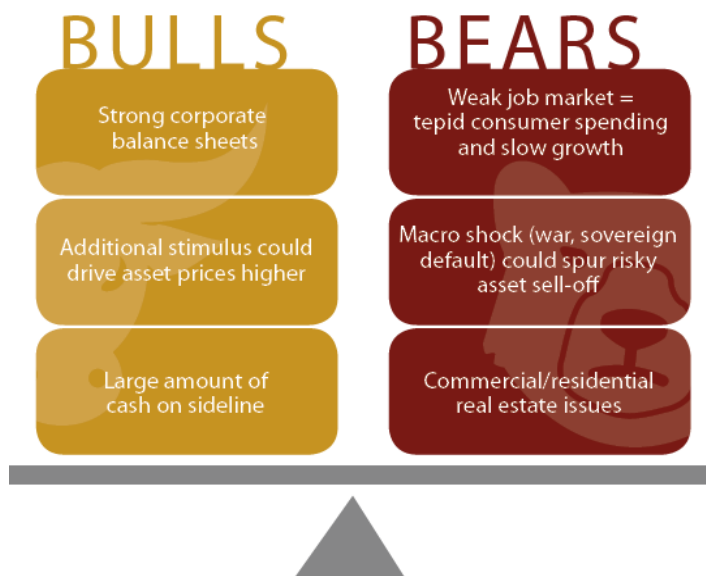
CREDIT YIELDS

Yields of U.S. Treasuries rose sharply in December, the fourth consecutive month of an abrupt sell-off. Some fear the Federal Reserve, which has been focused on stimulating the economy for the past two years, might not be able to react quickly enough to squash any future overheating/inflationary pressures.



SUMMARY OF CURRENT EQUITY MARKET LEANINGS

We are slightly underweight our strategic equity targets. U.S. equity is at a neutral allocation, while we remain underweight to developed international equity markets. An overweight to emerging market equity remains in place. The overall equity underweight, which we have been reducing over the past year, accommodates ongoing shifts to other growth asset categories (such as emerging market debt) where we can mitigate some equity risk.

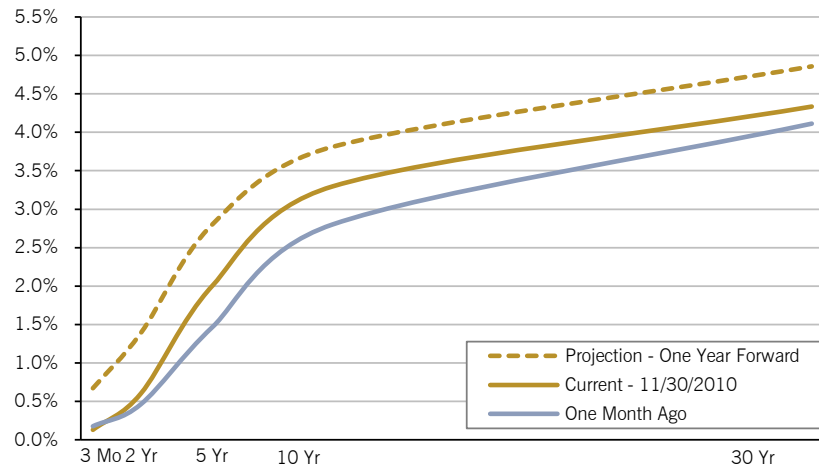


THE EQUITY AND FIXED INCOME MARKETS

U.S. TREASURY YIELD CURVE

The Treasury yield curve shifted significantly higher in December as bond funds saw large outflows. The muni market was particularly weak, as market analysts have projected soft demand for municipal debt in 2011 along with increasing yields. Despite some headlines, Moody's believes that municipal defaults will likely remain "rare, isolated, and idiosyncratic events."

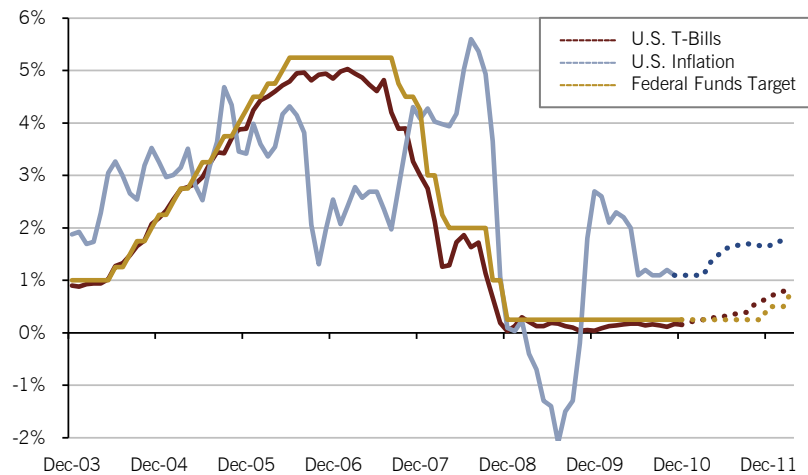
Advantage: Neutral



T-BILLS, FEDERAL FUNDS, AND INFLATION

With little immediate inflationary pressures, the Federal Reserve will most likely keep short-term interest rates near zero for some time. Longer-term, many fear aggressive easing measures by the Fed may lead to some form of inflation. At some point, though perhaps not this year, the Fed will need to alter monetary policy to address this risk.

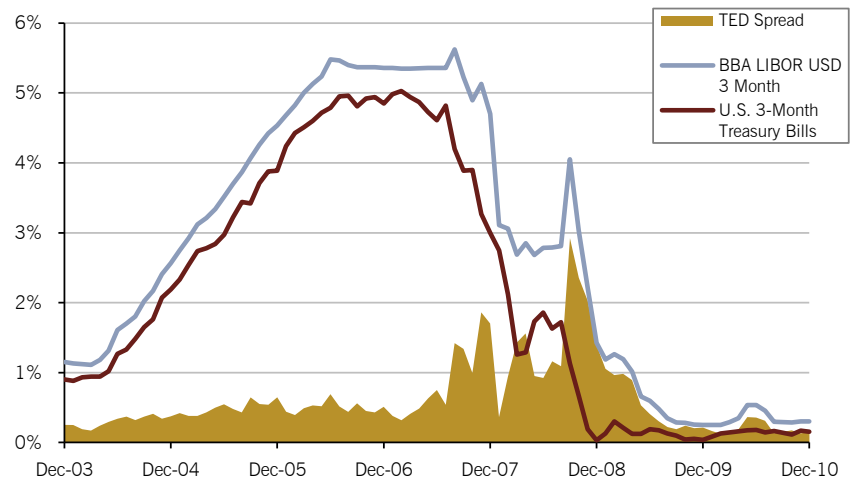
Advantage: Neutral



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). Current low spreads illustrate credit markets are operating with little anxiety.

Advantage: Bulls

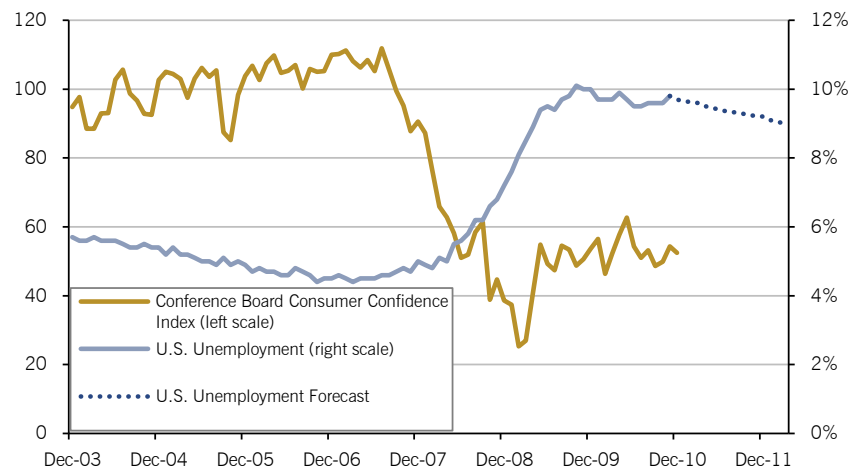


THE ECONOMY AND THE CONSUMER

CONSUMER CONFIDENCE AND UNEMPLOYMENT

Consumer confidence deteriorated in December due to worries about the job market and remains well below levels that signal a healthy economy. The labor market continues to improve, but at a painfully slow pace. While some companies have said they will start hiring in 2011, the Federal Reserve does not anticipate the unemployment rate to come down much this year.

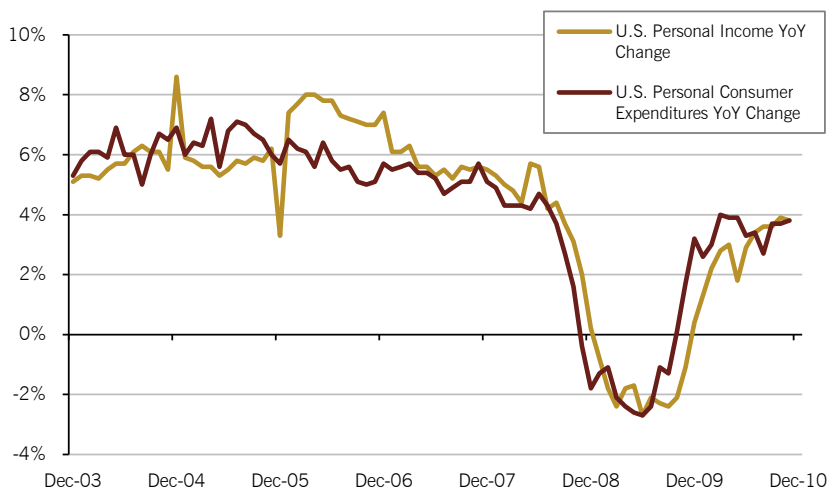
Advantage: Bears



U.S. CONSUMER INCOME AND SPENDING

The primary concern with high, lingering unemployment and low confidence is that consumers will not spend enough to rejuvenate the economy. Personal income, however, has shown surprising strength recently.

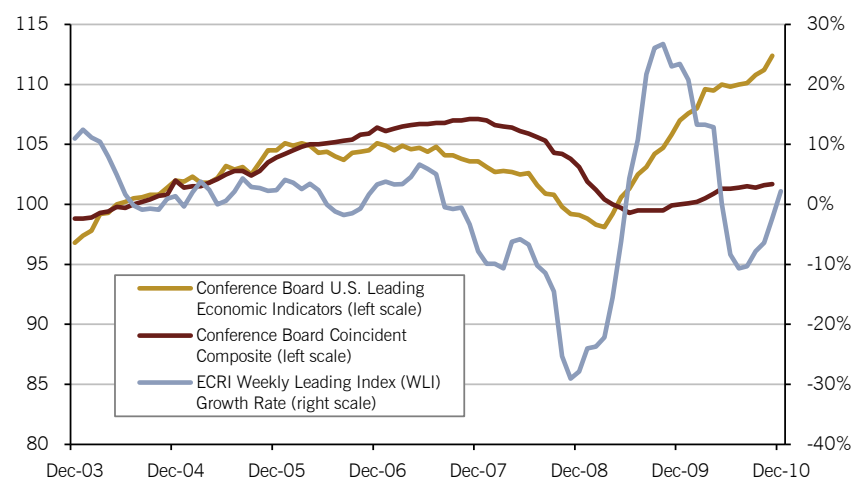
Advantage: Neutral



LEI AND ECRI

The U.S. leading economic index (LEI) continues to trend upward, suggesting the modest economic expansion will carry on in the near term. The index of coincident indicators has been mostly flat, illustrating the weakness of the recovery thus far.

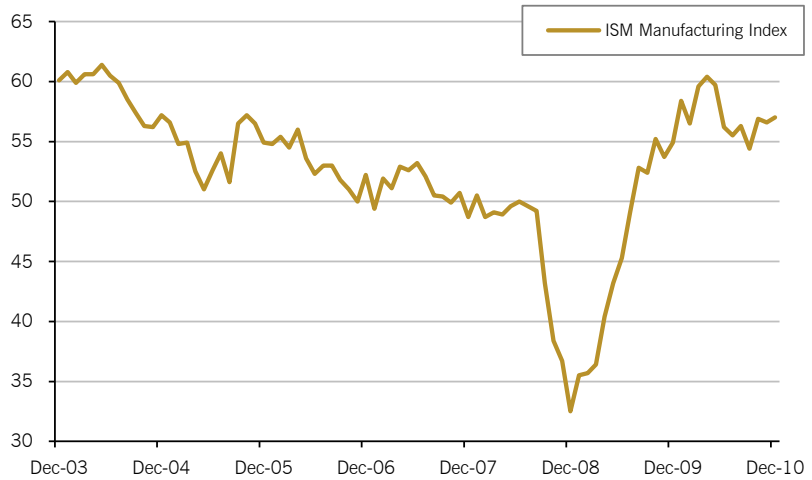
Advantage: Neutral



ISM MANUFACTURING INDEX

The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, prices, and export/import orders. A reading over 50% indicates expansion relative to the prior month, while a reading under 50% indicates contraction. The latest reading was the 17th consecutive month of expansion.

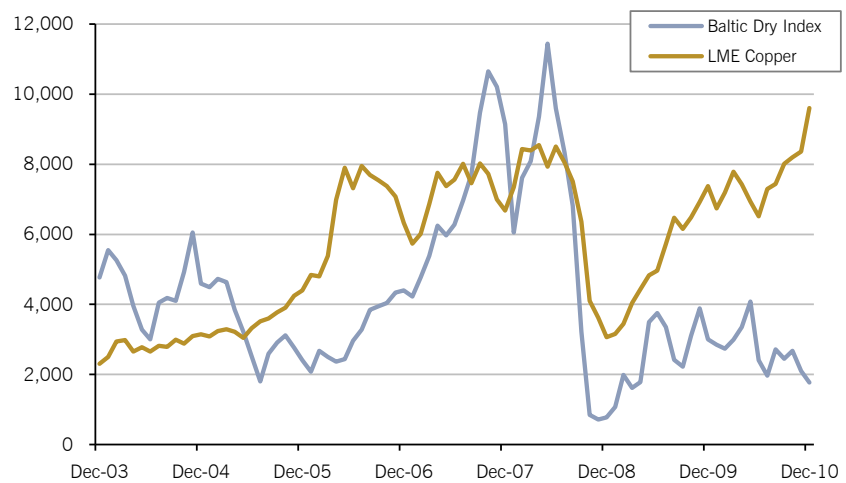
Advantage: Bulls



BALTIC DRY INDEX

The Baltic Dry Index (BDI) measures shipping costs for commodities and is used to evaluate world trade. Copper, a plentiful and heavily used metal in construction and manufacturing, can reflect trends in global economic growth. There has recently been quite a divergence between the BDI and the price of copper, and many feel the BDI says more about the oversupply of ships than demand for cargo.

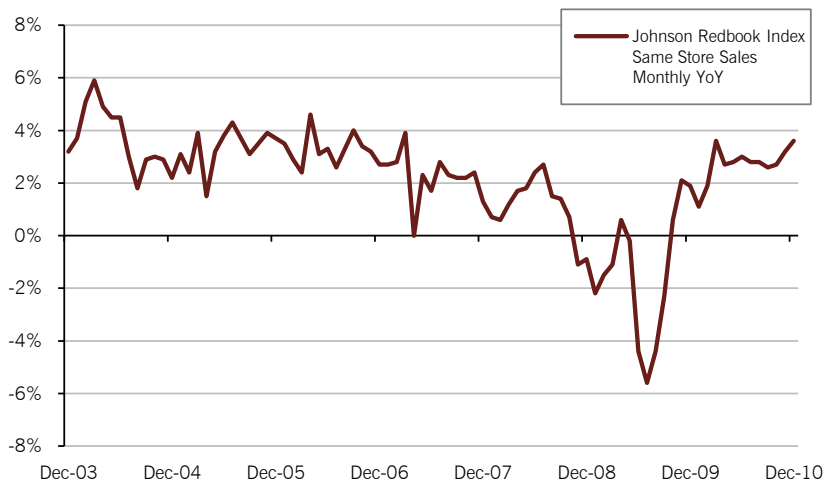
Advantage: Neutral



RETAIL SALES

Retail sales figures track the dollar value of merchandise sold to consumers and are an indicator of economic recovery. Store sales took off in the last two weeks before Christmas, and total holiday sales are expected to have been much better than a year ago.

Advantage: Neutral

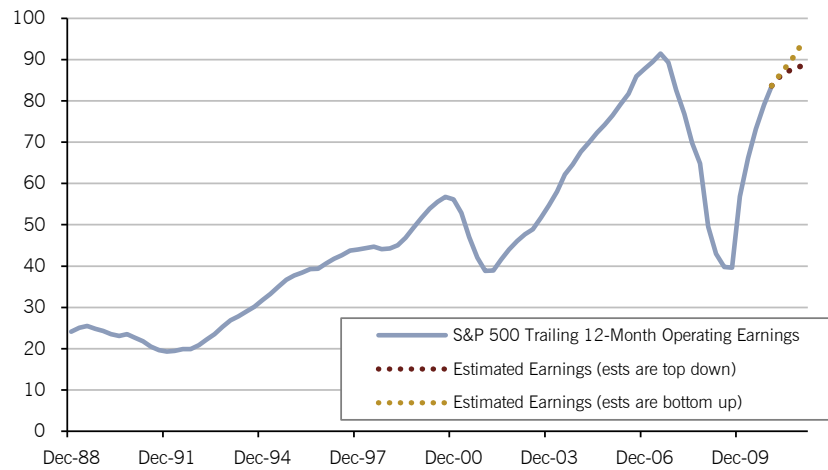


U.S. CORPORATIONS

CORPORATE EARNINGS

Earnings growth, which benefited in 2009/2010 from significant cost cutting, is expected to remain healthy (10+%) in 2011 as some revenue growth is sustained. Year-over-year comparisons to 2010 will be tough, however, because profits have looked so strong recently.

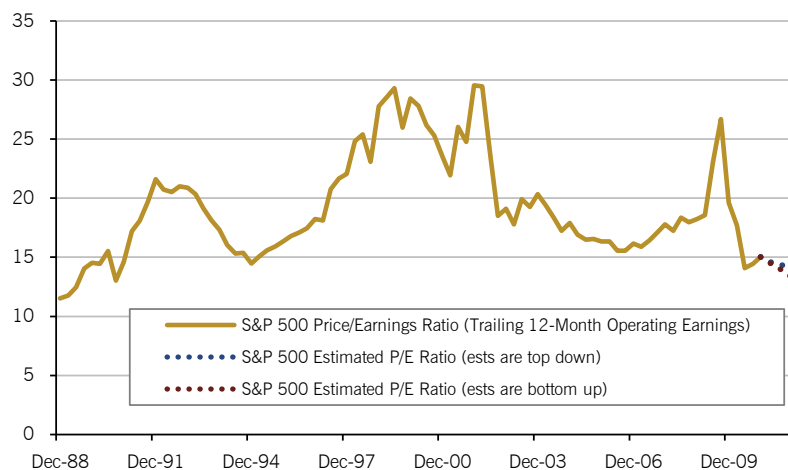
Advantage: Neutral to Bullish



STOCK MARKET VALUATIONS

Earnings growth over the past year has helped trailing 12-month P/E valuations look reasonable (slightly below historical norms) despite a run-up in stock prices. However, longer-term methods of measuring valuations, such as the ten-year real P/E pioneered by Yale economist Robert Shiller, remain a bit elevated (just over 22).

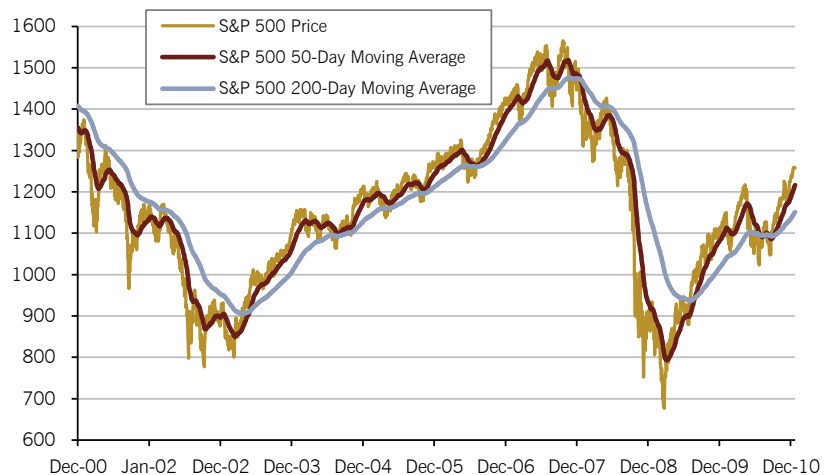
Advantage: Neutral to Bullish



STOCK MARKET TECHNICALS

After falling below the 200-day moving average for a brief period this summer, the S&P 500 50-day moving average crossed back into higher territory in September (the so-called "Golden Cross"). It remains there and is interpreted by many as a bullish signal.

Advantage: Bulls

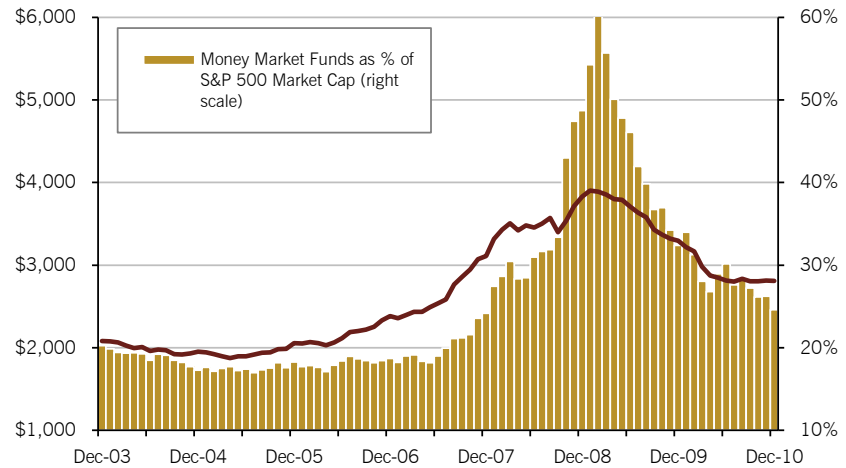


INVESTOR FLOWS AND LIQUIDITY

MONEY MARKET FUNDS ASSETS (\$ BILLIONS)

Money market funds declined 15% in 2010, decreasing from \$3.3 trillion at the start of the year to \$2.8 trillion by the end as a significant amount of cash was put to work. Still, there remains plenty of dry powder on the sideline available to be deployed.

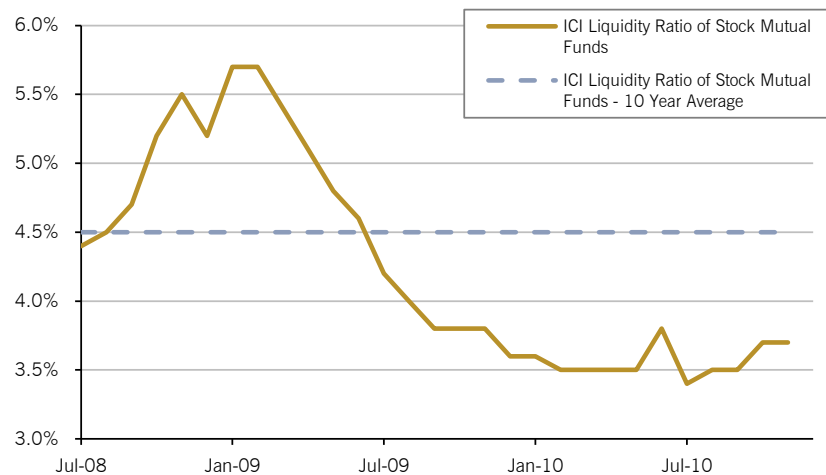
Advantage: Bulls



MUTUAL FUND LIQUIDITY RATIO

The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As stocks tumbled in 2009, mutual fund managers were bearish and sitting on a large amount of cash. Since then, managers have put most of that cash to work and throughout 2010 held unusually low levels of cash (meaning little in additional cash to invest).

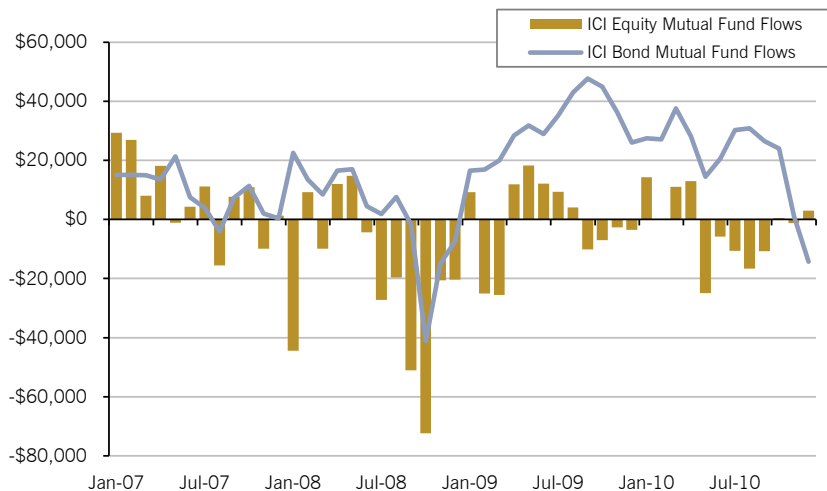
Advantage: Bears



MUTUAL FUND CASH FLOWS (\$ MILLIONS)

Despite the run-up in stocks in 2010, investors withdrew nearly \$28 billion from stock funds (both domestic and international) while adding \$254 billion into bond funds. December was the only month in which bond funds saw net withdrawals and lagged equity flows. Time will tell if this is a turning point for retail investor sentiment.

Advantage: Neutral

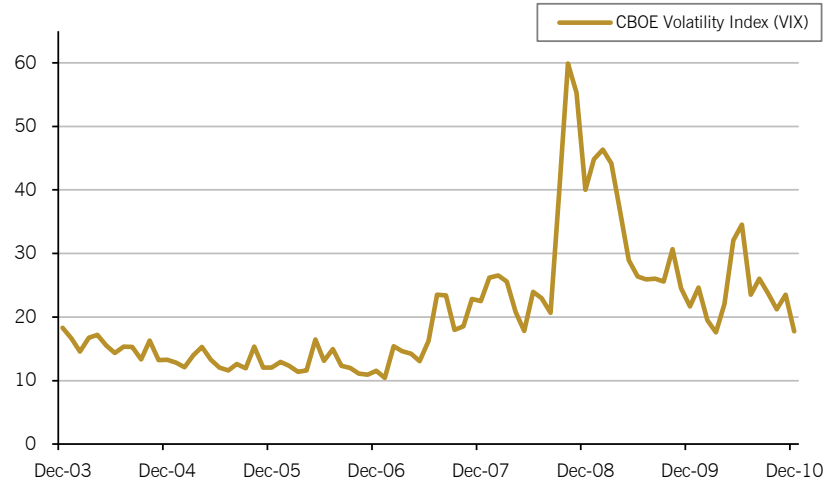


FEAR MEASURES

STOCK MARKET VOLATILITY

Volatility, as measured by the Chicago Board Options Exchange Volatility Index, fell mid-month to 15.5, its lowest point since July 2007, before ending December at 17.8. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful (or even complacent) times in the markets.

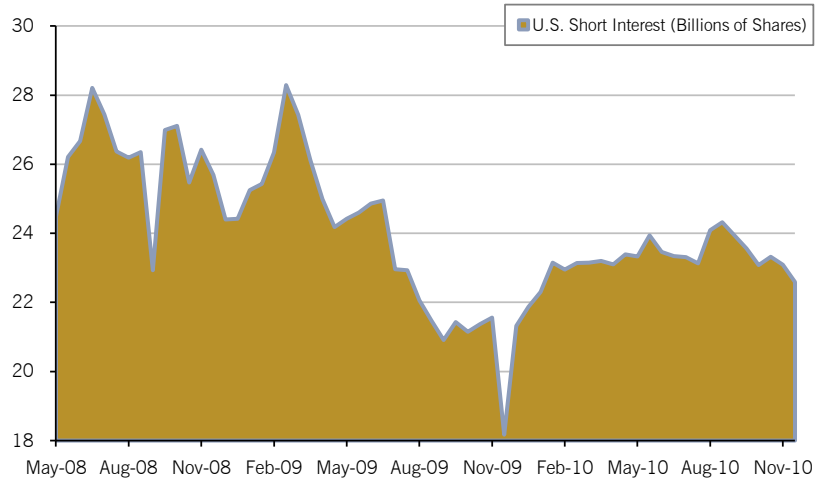
Advantage: Neutral



U.S. SHORT INTEREST

Short interest can be a measure 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.

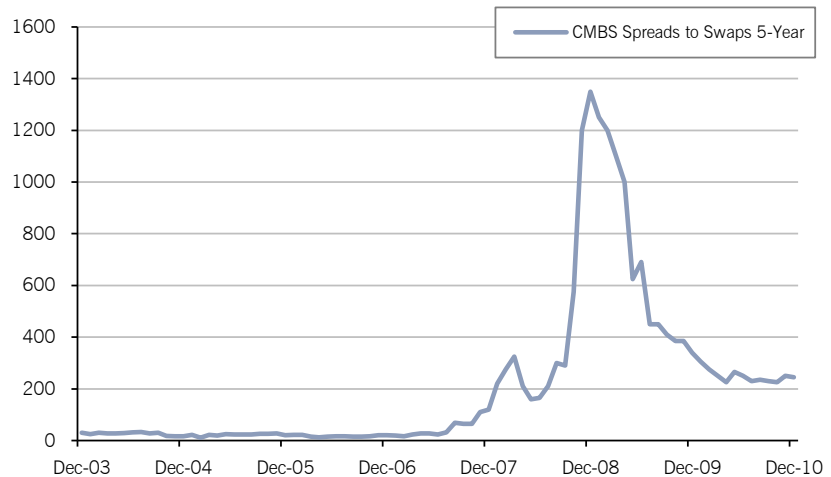
Advantage: Neutral



CMBS SPREADS

Even as delinquencies continue to rise, commercial mortgage-backed securities (CMBS) spreads have been stable and in a narrow range for some time, supported to some degree by government programs such as TALF and PPIP.

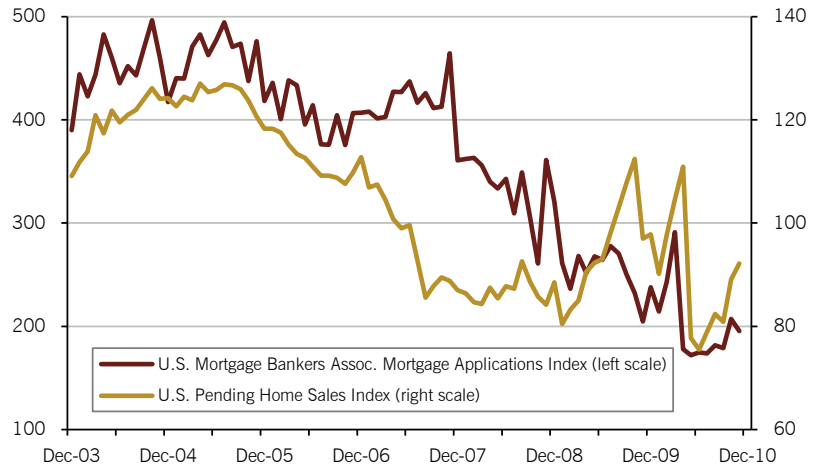
Advantage: Neutral



MORTGAGE APPLICATIONS AND PENDING HOME SALES

U.S. mortgage applications fell in December as higher mortgage rates led to a slump in new purchase and refinancing volume. Pending home sales have been seeing a pick-up, though recovery is expected to be uneven thanks to oversupply as banks deal with foreclosure issues.

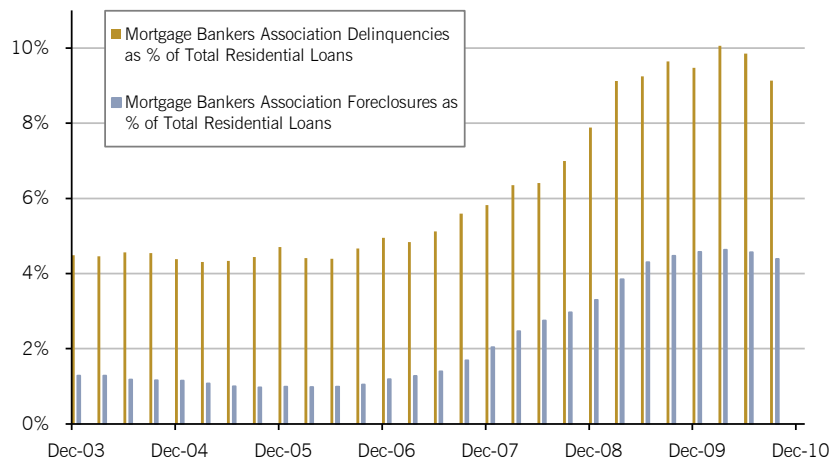
Advantage: Bears



RESIDENTIAL DELINQUENCIES AND DEFAULTS

Mortgage delinquencies and foreclosures remain near record levels. With unemployment stubbornly high and a large number of distressed properties that could reach the market in 2011, the housing market is expected to be a headwind to the economy for some time.

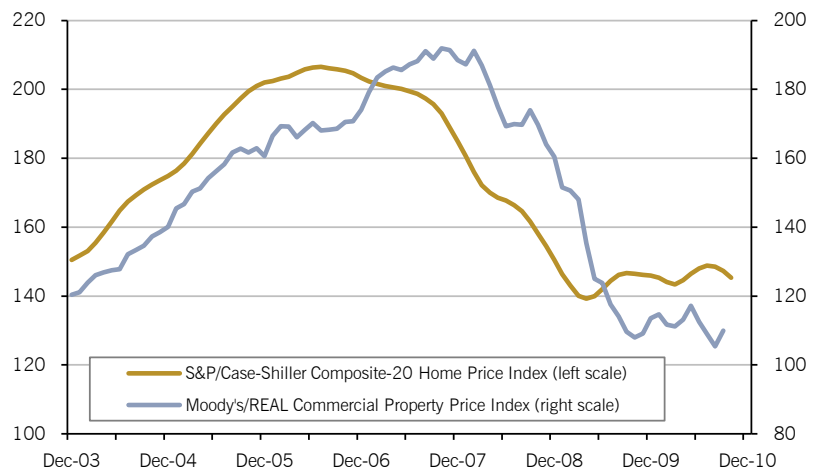
Advantage: Bears



RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES

The housing market has struggled since the home-buyer tax credit program expired last year and remains stuck near recession levels. Home prices continue to fall, pressured by high unemployment, foreclosures, and a glut of supply.

Advantage: Neutral to Bearish

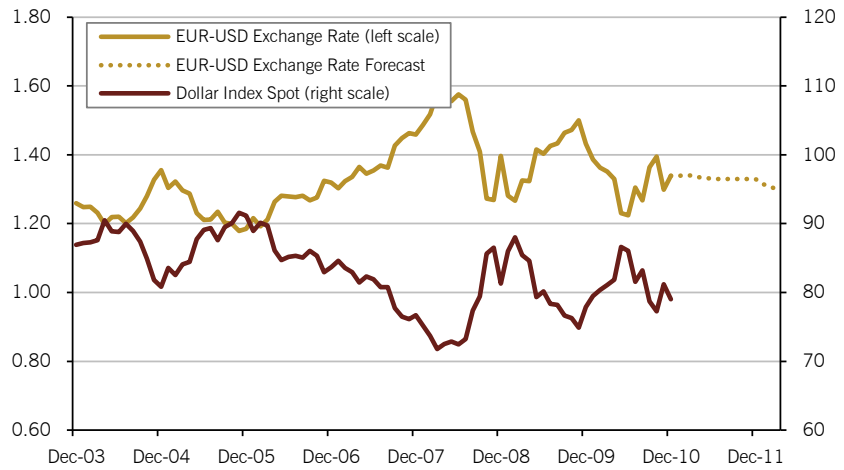


CURRENCY

U.S. DOLLAR

While the U.S. dollar weakened in December (the U.S. Dollar Index was down nearly 3% for the month) due to worries about the government debt burden and lackluster economy, the euro and yen have their own problems. A flight to safety could provide increased dollar demand in 2011, but many anticipate greater currency strength in other regions such as China.

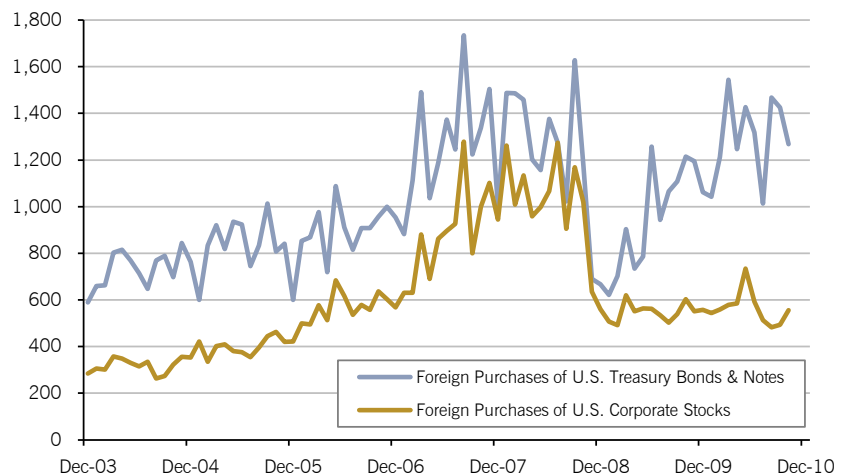
Advantage: Neutral



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

Global demand for U.S. bonds from foreign investors slowed noticeably in October. China, the largest foreign holder of U.S. Treasuries, sold long-term U.S. bonds while increasing short-term holdings. Any significant drop in foreign demand could lead to higher U.S. interest rates.

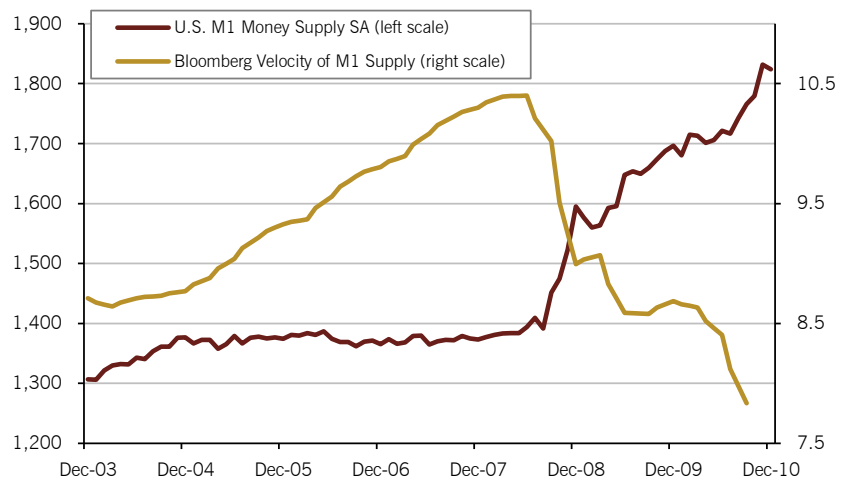
Advantage: Neutral



U.S. M1 MONEY SUPPLY AND VELOCITY

M1 consists of the most liquid forms of money, namely currency and checkable deposits. With the recent stimulus, M1 has spiked to unprecedented levels, causing fears of eventual inflation and dollar weakness. Velocity of money (the rate at which money changes hands), however, has actually been dropping as consumers and businesses are not spending or borrowing.

Advantage: Neutral to Bearish

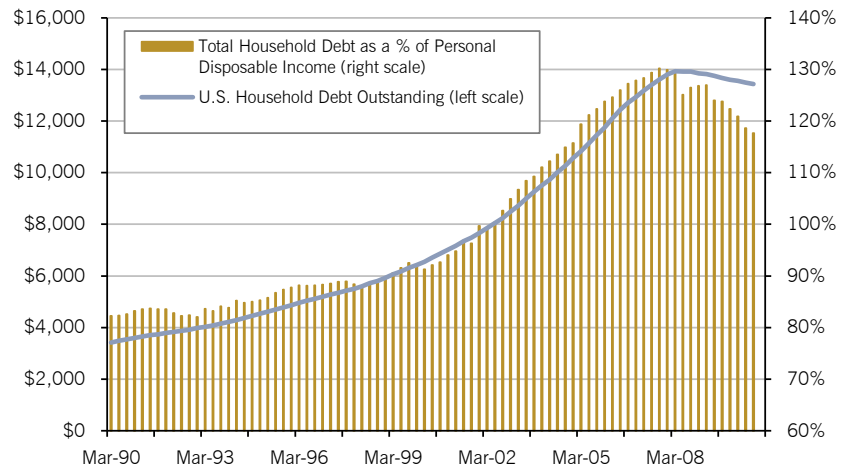


BORROWING

U.S. HOUSEHOLD DEBT AS A % OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit debt) and the percentage it represents of disposable personal income have increased dramatically since the early 1990s. Despite talk of a deleveraging cycle, consumers thus far have been decreasing debt slowly and still have a way to go.

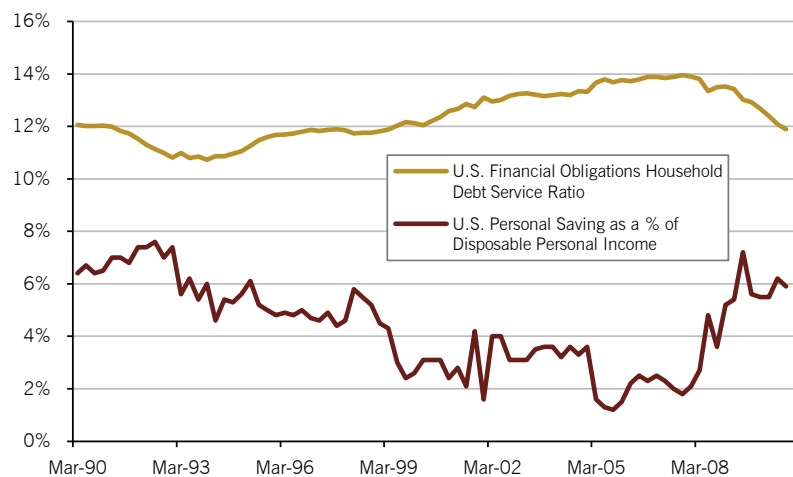
Advantage: Neutral to Bearish



U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures the amount households spend on debt payments as a percentage of their earnings. Despite the remarkable increase in total debt over the past few decades, the rise in service ratios has been more muted due to the decline in interest rates. If rates spike, however, so too would debt payments, which would be problematic.

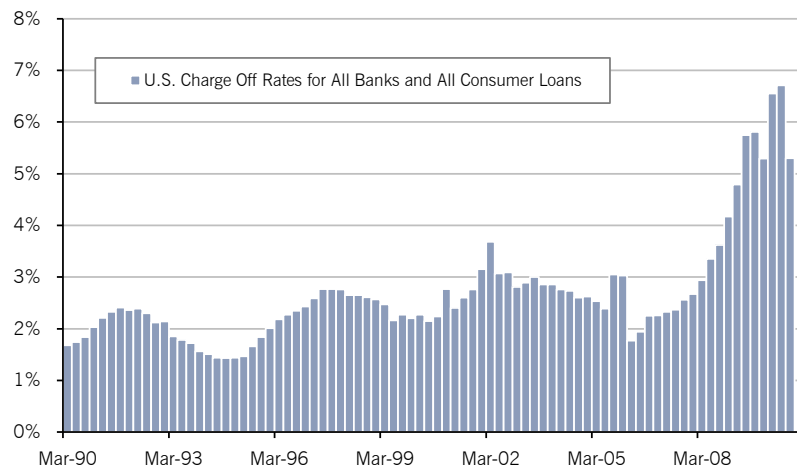
Advantage: Neutral to Bearish



U.S. CONSUMER LOAN CHARGE-OFF RATES

Despite low interest rates, U.S. consumer bank loans (including credit cards but excluding real estate) written off as unrecoverable remain near the highest levels on record. Personal bankruptcies were up as much as 25% in 2010 in states such as California and Arizona.

Advantage: Neutral to Bearish



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