Our Investment Approach & the Year Ahead

Reminiscing on 2011 evokes thoughts of the sport of boxing, and not simply because its roots lie in Greece. While some may view the sport as violent and barbaric, boxing is often referred to as the "sweet science," an engaging display of tactics and skilled craft. When looking at it this way, boxing is a great analogy for investing and can also be used to help explain Convergent's investment approach.

In boxing, as in investing, one must play offense and defense at the same time—looking for opportunities and taking risks in an effort to protect against losses and uncertainty. Often times, to be within range of hitting one's financial goals an investor must also be close enough to get hit with short-term volatility and market declines. 2011 was marked by significant volatility with ultimately little change in portfolio values. As a result, investors may feel a bit like boxers who entered the ring well prepared for the fight, only to experience unpredictable uppercuts and jabs and end the 2011 round in a tie.

The Four Corners: Our Investment Approach

Like the four corners in a boxing ring, we seek to add value through the four pillars of our investment approach—strategic asset allocation, tactical overlays, manager selection, and systemic hedges.

1. **Strategic Asset Allocation:** The best performing asset classes in 2011 were mostly credit related, similar to 2001 and 2008 when equity markets in general were anemic. Throughout the year, macro concerns drove investor behavior and, in turn, asset class returns. We view this as a temporary phenomenon and we are confident that fundamental factors and valuations do still matter and will ultimately determine long-term results. History has proven that diversification across asset classes provides excess return with reduced volatility over the long term, and we view our plan of diversification as a winning strategy and one which we will maintain.

2. **Tactical Portfolio Positioning:** Not unlike a boxer who might switch stance in response to an opponent, we make adjustments to our strategic allocations if market conditions dictate. Our tactical shifts toward gold, Treasuries, and mortgages—along with our focus on high dividend companies—benefited our portfolios in 2011. The tactical decision that did not work as well was our underweight allocation to core bonds, an asset class which held up surprisingly well through the year. Despite its performance, we remain underweight core fixed income because we believe bonds will have difficulty replicating these strong results going forward. Low default risk bonds have little potential for upside due to historically low yields and the potential for an increase in interest rates.

3. **Manager Selection:** Just as boxers bring a team of experts to the ring to improve their chances for success, we hire managers to carry out the same function in our portfolios. Due to the high correlations, low interest rates, and markets trading on global news as opposed to fundamental factors, value added from manager selection last year was limited to a few asset classes. However, we believe active management will improve as macro factors become less influential and company specific fundamentals return as the main driver of returns.

4. **Systemic Hedges:** The fundamental purpose of boxing (and a key tenet of our investment philosophy) is to hit and not get hit. Systemic hedges are how we protect against the next blow without sacrificing all forms of offense (risk assets) and the ability to meet financial goals. In 2012 we will continue to incorporate an allocation to hedges such as gold and Treasuries. Some risk exists given the potential for unexpected events (wars, natural disasters, etc.). Accordingly, our allocation to gold and Treasuries is designed to help guard against this and other unexpected areas of macro risk.

Looking Forward to Round 2012

Though we've turned the page on the calendar, not much has changed from an investment standpoint. The world is still likely to move in fits and starts given fear over the European debt situation as well as the inherent risks in the outcome of the U.S. debt and Chinese economic growth scenarios. One thing we know for certain is that equities are generally cheaper than they were at the start of 2011 and, absent a catastrophic event, could perform relatively well compared to bonds. We remain on target with regard to overall stock exposure, with a tilt toward U.S. dividend paying companies and beaten-down emerging markets.

In 2012 Europe will, of course, be a focal point for us, and we will evaluate the following questions: Is a European recession/cataclysm priced into the market already? Would a European recession spread to the U.S. or to emerging markets? Will the Euro or banking sector collapse?

We are currently underweight Europe and will remain so until there is more clarity around its leaders' plans and their abilities to exit the clutches of a disaster. Our biggest concern, which explains our underweight allocation to Europe as well as our overweight to systemic hedges, is a global financial/credit market disruption—or, worse yet, seizure—due to European sovereign or bank collapse.

With respect to the U.S., we expect the economy to continue to expand in 2012, though a European collapse certainly presents some level of downside risk to the U.S. equity markets. We believe expansion will continue at a slower-than-historical trend, while unemployment and housing will remain weak. However, corporate balance sheets and earnings should remain strong, setting the stage for a potential equity rally once some of the uncertainties are resolved.

As for emerging markets, our concern in the short term is a hard landing in China. However, global valuations are attractive and we strongly believe in the long-term worldwide growth story—particularly with regard to emerging markets—which explains our overweight to these regions.

Fundamentally, we remain confident that over reasonable investment horizons stocks should outperform bonds and bonds should outperform cash. It's truly that simple. Capitalism is alive and well across the globe and is likely to remain the heavyweight champion long past our time on this earth.

In summary, we plan to keep our defenses alert and rely on balance and diversity in skills, with the goal of being positioned to do well in a variety of scenarios. Remember, you have to be in the fight to win it.