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Our longer-term analysis suggests that stock returns are likely to be mediocre.

Likely returns from bonds are even lower than stocks.

As a result, we are underweighted to stocks and bonds in favor of fixed-income and alternative strategies that offer competitive returns at less risk.

With muni bonds, the overall market is currently pricing in a default level that we believe is much too pessimistic.

Things could turn out more positive than we expect, but even if they do the underlying problem of too much debt can't be fixed without hurting economic growth.

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Quarterly Investment Commentary

We Are Not Perma-Bears, But We Are Cautious Now

For various stretches over the last 13 years we have been cautious towards the stock market based on our assessment of market valuations and expected returns. This has frustrated our clients at times, the late 1990s being the most notable example, as the S&P and Nasdaq rocketed higher during the late stages of the tech bubble. We wrote about our market concerns at that time, and our caution proved to be warranted. Despite another bear market in 2008, all of our portfolio models outperformed their benchmarks during this period, though there were a couple of performance slumps along the way—notably in 1998 and 2008.

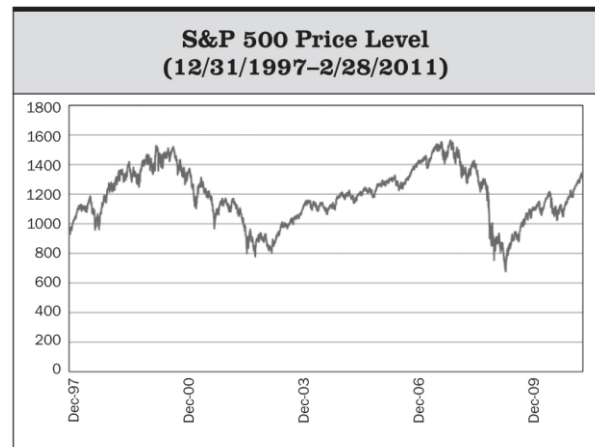
As we reflect back and look forward, there are several points worth emphasizing.

1. Our valuation-driven, scenario-based approach is designed to help us make good decisions over the long-term. We know we can't predict the short-term with consistent accuracy.
2. Even in the midst of long periods where returns are low there are still opportunities. In fact, these low-return periods are often characterized by higher volatility that can offer occasional fat pitches in “risky” asset classes like equities, REITs, and high-yield bonds. We have been able to take advantage of a number of fat pitches in each of the last two market cycles and they have contributed significantly to our return premium over the benchmark during this period.
3. We are not perma-bears. There have been extended periods over the past decade where our equity exposure was at a neutral level and/or our actual “equity like” exposure was at or above neutral (taking into account exposure to asset classes that have some equity-like risk such as high-yield bonds and REITs).

Currently, we are positioned somewhat conservatively with our portfolio allocations, and there are a few important points to make

in this regard.

First, our longer-term analysis suggests that stock returns are likely to be mediocre over our five-year time frame—most likely somewhere in the low-single-digit range. We analyze return ranges for stocks by considering the possible economic scenarios we could see, and then considering how the “building blocks” of equity returns—dividends, earnings growth, and multiples—stack up under each. A challenge is that the range of possible outcomes is unusually wide, ranging from another recession to a return to the “old normal” patterns of borrowing and spending. We believe the odds skew towards the more negative outcomes, and this impacts how we want to allocate our portfolios.



Stocks have gained little ground over the past 13 years.

Second, likely returns from bonds are even lower than stocks. With interest rates quite low, and longer-term inflationary pressure likely to result from our government’s fiscal policies and challenges, it is far more likely that we will see rising rates (which push bond prices lower) than falling rates over our investment horizon. Without the tailwind of falling rates, and with yields on bonds starting at low levels, we expect only very low single-digit returns from core high-quality bonds. Ordinarily, if we believe equity returns are likely to be higher than bonds, it would argue for being fully weighted to equities to capture that higher return.

That brings us to our third point, which is that with low expected returns for stocks and bonds, *and* with significant big-picture risks out there that could damage returns (especially in the shorter-term), we are underweighted to both stocks and core bonds in our balanced portfolios in favor of investments that we think collectively offer better or at least competitive returns at less risk.

Examples of portfolio positions that we believe offer a better risk-reward tradeoff include: short-term high-yield bonds that offer better yields but generally low default risk thanks to their short maturities and careful credit research (Osterweis Strategic Income); flexible, absolute-return-oriented bond funds that have a broad toolkit with respect to the types of bonds they can own and their ability to limit the risk of rising rates (PIMCO Unconstrained); floating rate funds that generate good yields but that are not exposed to the risk of rising rates, and arbitrage strategies that are able to earn a return without the tailwind of rising stock prices.

These investments are generally a little riskier than core bonds in that they would provide less protection from a severe downside scenario such as recession or deflation, but they are significantly less risky than equities. Since these positions are funded from reductions in both stocks and bonds, the net effect of these positions is to reduce overall portfolio risk while generating as good or better returns in most scenarios.

We have two other fixed-income investments that come with a notch-higher risk than the investments described above, but that similarly offer better bang for our risk buck. The multi-sector Loomis Sayles Bond invests in (among other things) carefully selected high-yield bonds and foreign

bonds, mainly of commodity producing countries, which provides some hedge against a falling dollar. The other fund—PIMCO Emerging Local Bond—invests in the bonds of emerging-markets countries and is a more direct-dollar hedge. It offers an attractive 7% yield and the chance for greater currency appreciation if our longer-term assumptions that the dollar will decline prove correct.

Our core investment-grade bond exposure is achieved mostly via PIMCO Total Return and municipal bond funds for taxable portfolios. Given the media focus on state and municipal finances, we want to share briefly our view on municipal bonds.

For taxable portfolios, municipal bonds are still a core position. This sector of the bond market has been in the headlines for months with some commentators making doomsday forecasts of massive defaults. This asset class is hard to evaluate on an aggregate basis because of the lack of underlying fundamental data and the fact that there are about 60,000 different bond issuers. We've approached our analysis by talking to and reading the analysis of experts in our network, reviewing research and data, and studying the structural factors that affect the finances of different types of muni issuers. We believe the massive default forecasts are greatly exaggerated. While defaults are almost certain to increase among smaller local issuers and will likely be higher than in past cycles, we believe there are plenty of solid muni credits available to bond managers.

Scattered high-profile defaults are entirely possible and these could spook investors and trigger more temporary nasty sell-offs for the broader municipal bond market, so we expect higher volatility than taxable investment-grade bonds. But the overall market is currently pricing in a default level that we believe is much too pessimistic—many muni bonds are offering tax-free yields that are higher than taxable U.S. Treasury yields. If municipal yields relative to taxable bond yields normalize over five years (the muni yields normally are lower since they are exempt from tax), investors may be able to capture returns that are nearly as high as the current yields, even in light of the rise we expect in the general level of interest rates. This should equate to pre-tax equivalent returns of around 5%, much better than the returns we expect from taxable investment-grade bonds. This makes municipal bond funds a decent asset class to own for the conservative portion of our portfolios for those who can accept the higher shorter-term volatility.

The final point we would make about our conservative positioning is that if we continue to see strong stock returns, it is likely our portfolios will lag their benchmarks. And while we did manage to outperform in 2010 despite a sharply rising stock market, we trailed in the very strong fourth quarter and again in the first quarter of this year. It may seem odd to be cautioning clients about the "risk" of stocks continuing to march higher, but it is worth considering what that risk really is. The risk is that rising markets leave investors feeling that they missed the boat, which leads them to increase their equity exposure at a time when high stock market valuations offer less longer-term return potential and greater vulnerability to a correction.

We are often asked: "What if you are wrong and stocks just keep going up"? Stocks can keep going up in the shorter-term, and this is not something we are confident in our ability to predict. But over the longer-term, which we can analyze with more confidence, an important driver of stock returns will be earnings growth, and this is highly correlated to the overall economy. So could the economy perform well enough to continue to drive the kinds of stock returns we've been seeing? Consumers could ramp up spending, and take on more debt, and the jobs and housing pictures could improve more quickly than we expect. But even if that happens to some degree, the deepest underlying problems aren't going to go away as a result.

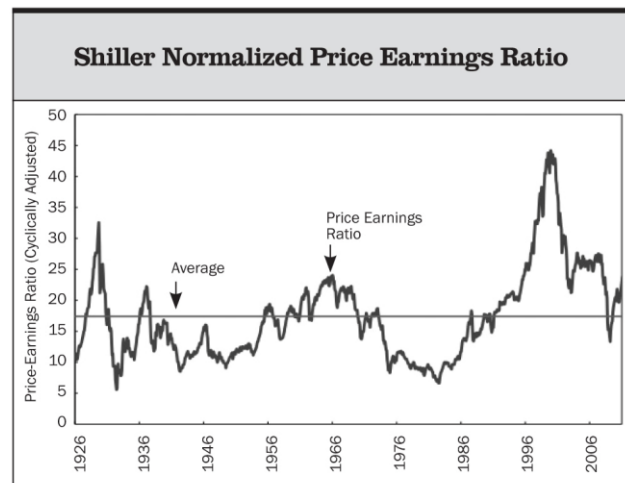
The deeper problem is that we have gone through a massive build-up of debt that occurred over many decades, and a lot of it still remains. Some of it has effectively been shifted to the government. With large deficits, a growing national debt, and entitlement spending on track to make these problems significantly worse over coming years and decades, it is inevitable that at some point as a nation we will have to take our medicine. When we do, it will mean we borrow less and spend less, which will reduce economic growth, and that will be a drag on corporate earnings and therefore stock returns.

It is in considering the headwinds the economy faces in the years ahead, and factoring in other big-picture risks such as Europe's debt problems, unrest in the Middle East, Japan's disaster, and other possible shocks we can't foresee, that we conclude that the returns stocks are likely to earn aren't sufficient to compensate us for taking on the risk. We've often said that we view investing as a marathon, not a sprint. We all are investors over a lifetime and any one year is a small slice of our investment timeline. Over our investing lives there will be periods when it pays to be conservative and others when it makes sense to be aggressive. Sometimes these periods will be short, others times they will last for years. Along the way there will be ups and downs within each of these periods. Our challenge is to ignore the ups and downs and focus on the potential returns we believe we can capture and weigh them against the risks.

Ultimately, what drives our risk-taking is the presence of a margin of safety, i.e., a significantly undervalued asset, such that even in a bad scenario it shouldn't have much downside. Today we believe there is an inadequate margin of safety in the stock market. Valuations are not attractive enough to compensate for the many serious concerns we've mentioned that could impact investment fundamentals. And because we have other investments that can generate competitive returns at less overall risk, we are not concerned that over the longer-term we are giving up a lot of opportunity even if we see a scenario that is better than we expect.

Meanwhile, it is worth noting that despite our significant equity underweight, our net "risk underweight" is less than it seems because many of the investments described carry higher risk than bonds, from which they are partly funded.

Two final points about return expectations are that the equity managers we own can boost returns through outperformance, and many are indicating that at the stock-picking level they are finding good opportunities. Additionally, we are confident that inevitable periods of fear will drive certain asset classes lower and present us with opportunities to earn much more compelling returns in exchange for ratcheting our risk higher. This discipline and longer-term focus, along with careful underlying research, is the core of what we bring to the table as investment advisors.



Except for the periods encompassing the tech and real estate/debt bubbles, the only other times the P/E has been this high was in the late 1920s and mid-1960s. Both periods preceded long and deep bear markets.

—Research Team (4/2011)