

Walden Capital Newsletter

Walden Capital Advisors

Fourth Quarter 2009

We have enjoyed strong absolute and relative returns this year after a difficult 2008.

While the economy has shown signs of recovery, there is still a long road ahead. Unlike 2008, there were many positive developments in 2009. Much uncertainty still exists with respect to the economy and financial markets as many issues are still unresolved. Some of these include the levels of household and government debt, consumer spending, and how and when the government will unwind the stimulus.

We are introducing two additional asset classes to the portfolios. These changes are designed to reduce volatility in the equity allocation and provide better protection in down markets.

In this Issue

- **Quarterly Investment Commentary**
- **2009 Highlights**
- **Looking Forward**
- **New Ideas for 2010**

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Quarterly Investment Commentary

When the dust settled on one of the most eventful and upended years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large cap stocks, as measured by the S & P 500 Index, gained about 6% in the final quarter, and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. Mid-caps were a different story; while the Russell Midcap Index posted fourth-quarter returns in line with the overall market, full-year returns were just north of 40%.

On the domestic fixed income side, returns varied widely in 2009. The Barclays US Aggregate Bond Index gained 5.9% for the year, but the Barclays US 5-10 Year Treasury Index was down 4.8% and the Barclays US 5-10 Year Credit Index gained almost 19%. High yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, instead crushed both, with the Barclays US High Yield Index gaining 58% for the year.

Heading overseas, the story was emerging markets. The MSCI Emerging Markets Index tacked on 8.6% in the fourth quarter to bring its full-year gain to 79%, versus a gain for the developed market MSCI EAFE Index of 2.2% for the quarter and a still impressive 32.5% for the year.

As compared to 2008 when our international allocation hurt returns, our exposure to both developed international countries and emerging markets helped in 2009. Additionally, mid-cap equities, growth equities, commodities and high yield bonds all contributed favorably to performance in 2009.

2009 Highlights

After a disastrous 2008, listed below are some of the highlights of 2009:

Market Rebound: Following a second large downturn in the first quarter of the year that made everyone fear a complete meltdown of the financial system as we know it, the market turned around abruptly and showed signs of stabilization in the second quarter. Investors went from complete risk aversion to slowly moving back into the markets as they rebounded fiercely during the middle of the year.

Quantitative Easing: The Federal Reserve showed its true might through its willingness to take unprecedented measures to ward off an even worse crisis by injecting extraordinary liquidity into the financial system.

Emerging Markets Lead the Way: Emerging markets went from the worst performing asset class in 2008 to the best in 2009, with the MSCI Emerging Markets Index increasing 79% for the year.

Return of Corporate Profits: Corporate profitability returned in 2009 after a significant decline in the fourth quarter of 2008. This came at a cost though as companies achieved this higher level of profitability primarily through cost cutting and inventory reduction resulting in an unemployment rate of over 10%.

Reversal of Fixed Income Returns: The fixed income market showed very strong returns for the year, with the riskiest assets such as high yield bonds performing best. This was a complete reversal from 2008 when the flight to quality led government bonds to significantly outpace all other fixed income sectors.

Real Estate Stabilized: After falling by 30% since the peak in 2006, real estate prices seem to have found some stability. Though not out of the woods as foreclosure rates are still high and many areas remain troubled, stemming the freefall we had witnessed in this sector was a positive development.

Financial Firms Survive and Thrive: Many financial companies started the year on the verge of bankruptcy only to end it being able to tap the credit markets again, pay off much of the TARP money and pay large employee bonuses. While the banks are still struggling with consumer and real estate loan defaults, their balance sheets, stock prices and viability all increased significantly during the year.

Looking Forward

As we'll note below, there are many factors which could hurt the return potential from either stocks or bonds at this point, but we are optimistic that periodic dysfunction in the markets will allow our managers to continue to find opportunities as well as allow us to take advantage of tactical opportunities. The incremental value of these opportunities may be much lower than it was this past year, when absolute returns were unusually high, but in a low-return environment they can still make a difference.

As we look ahead to 2010, the general consensus is that we should not be expecting another year of mid-20% returns. Instead, many analysts are forecasting a return in the high single digit range. Despite the beginnings of an economic recovery, which at this point has been mostly government supported, there is still a tough road ahead for the economy and the financial markets. Some of the concerning factors are as follows:

Debt, Debt, and More Debt: We are still in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the acceleration of the buildup of our public (government) debt.

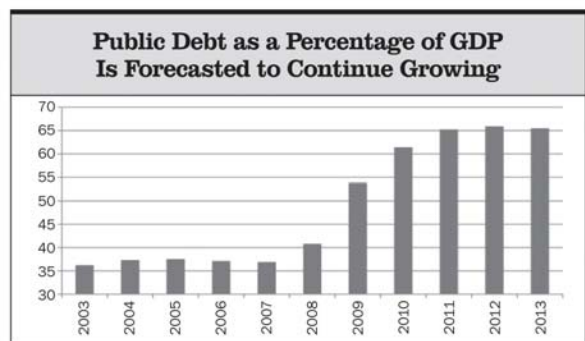
Household Debt: Households have hit a debt wall and are in the process of deleveraging. Despite the huge government stimulus, this process is not over.

Consumer Spending Headwinds: Because consumer spending is 70% of the economy, it is very important to overall economic growth. The desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it likely that consumption growth will be less than what we have been used to.

U.S. Government Debt Explosion: The U.S. Government's actions in aggregate probably saved us from a 1930s-type depression. However, the resulting leap in the government deficit comes at a bad time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the U.S. faces extremely challenging times in the coming years. As debt continues to grow, at some point it will become difficult to get investors to lend to a fiscally challenged U.S. in the amounts needed without paying a significantly higher interest rate. Though some increase in borrowing costs is likely soon, the risk of a sharp increase in rates is not imminent if the recovery is subpar. But looking out over the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and spending will have to decrease. If this doesn't happen in a significant way, there is a risk of both dollar and interest rate issues that could be painful for the U.S. and global economies.

There are still many variables in play that relate to these concerns, including a slower than anticipated recovery for the labor market; the wave of upcoming foreclosures and continued high unemployment; small businesses suffering from weak demand and a larger decline in profits than bigger firms; states and municipalities suffering from the steepest decline in tax revenue on record; and loan delinquency rates continuing to increase.

Given the challenges, there is risk of policy mistakes as the Fed and the Treasury attempt to maneuver through the next few years.



Stimulus spending and falling tax receipts have caused a spike in public debt. The debt burden is forecast to worsen significantly due to the increasing cost of entitlement programs like Medicare and Social Security, and of servicing the national debt.

Unwinding of the stimulus at the right time and in the right way will be one of the big challenges. At what point the economy can stand on its own remains an open question, not just in the United States but in most of Europe and Japan as well.

The question of whether we will have inflation or deflation remains unresolved. With high levels of liquidity in the financial system and high government debt levels, the threat of inflation remains out there, although probably not in the very near term. We have seen a contraction in bank lending, an increase in consumer savings, high unemployment, and a negative consumer

price index for the first time in many years. This all means that the threat of deflation has not disappeared. Despite the fact that the recovery is occurring, albeit slowly, the very fact that both inflation and deflation remain reasonably likely underscores the large amount of economic uncertainty that still exists.

There are some positives, however. This is the largest global stimulus ever to occur in peace time. Strong emerging markets economies are feeding back into the global economy, which is a positive for exports and manufacturing. Corporate balance sheets, outside of financials, are in good shape with the best liquidity in 50 years. Inventories are low and a rebuilding cycle is beginning, which will support growth. And, the severity of the economic contraction and corporate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring.

New Ideas for 2010

We have learned from these past two years that no one can predict with certainty what lies ahead and the best strategy is to stay focused on your goals ahead and prepare your portfolio to perform appropriately in varying market conditions.

On that note, we will introduce two new asset classes into our investment models this year, Diversifying Strategies and Real Assets. These new sectors have lower correlations with the equity markets and by shifting a portion of the equity allocation to these sectors, our goal is to reduce volatility and provide greater downside protection. These funds still hold equities so they are not without risk but they either hold assets with lower correlations to equities or the managers have the ability to trade long and short based on market conditions. During the recent downturn, many of these managers

were down but not nearly as much as the general equity markets. If the markets go straight up from here, which we do not believe is a likely scenario, the addition of these sectors may cause the portfolios to underperform; however, in a down or sideways market, these moves are designed to enhance overall performance.

As we meet and talk with clients this year, we also want to introduce a new way of viewing your assets – earmarking them into three buckets – one for short term liquidity (1-3 years), another for the mid-term (years 4-9), and the last for long-term growth (10 years or more.) By assessing what your capital needs are for each of those periods, we can reevaluate your overall asset allocation to make sure that you have some assets more conservatively invested to weather the storms that will come in the future. As we have discussed in the past, there is a delicate balance between preserving assets for the years to come but allowing them to grow so that they meet your future needs.

Our goal is to help you achieve yours. Thank you for allowing us to help you in that process. We appreciate the confidence and trust you have placed in us.

Please contact Walden Capital Advisors promptly if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account.

Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.