

Walden Capital Newsletter

Walden Capital Advisors

First Quarter 2010

The first quarter of 2010 was a good one, with U.S. stocks enjoying healthy gains and bonds earning small positive returns.

The many positives in the current landscape indicate that the economy is recovering. We do not yet know what shape the recovery will ultimately be, however, because many concerns and uncertainties still exist in the mid-term outlook. The length and rate of the recovery will depend on the resolution of these issues.

We are continuing to rebalance the portfolios to include diversifying strategies and real asset funds as well as additional fixed income funds. These moves are designed to protect better against future downside risk while still capturing much, but not all, of future market upside potential.

In this Issue

- **Quarterly Investment Commentary**
- **The Current Landscape**
- **Portfolio Positioning for the Uncertain Times Ahead**

This Newsletter is mailed quarterly to our clients and friends to share some of our views. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Walden Capital Advisors with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.

Quarterly Investment Commentary

Following a strong March, all domestic equity asset classes are now well into positive territory year-to-date. The large-cap S & P 500 Index was up 5.4% for the quarter, while the Russell Midcap Index gained 8.7% and the small-cap Russell 2000 gained 8.9% for the first three months. Foreign stocks also posted strong gains in March and are now in the black for the year so far, with the MSCI EAFE Index and the MSCI Emerging Markets Index up 6.3% and 8.1% for the month, and 0.9% and 2.5% for the quarter, respectively.

Turning to fixed income, the Barcap US Aggregate Bond gave up a bit of ground (-0.1%) in March, though it posted a positive 1.8% return year-to-date. Developed foreign bonds (as represented by the Citigroup World Government Bond Index) slid 1.7% in March and are down 1.3% for the year so far. Emerging-markets bonds gained an impressive 4% for the month (as measured by the JPMorgan GBI-EM Global Diversified Index), ending the quarter with a 5.4% return. High-yield bonds posted a 3.1% gain in the month, ending the quarter up 4.8%.

The Current Landscape

A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. The powerful rally in “risk” assets over the past year is certainly comforting. While we take some satisfaction in the returns we’ve achieved for our clients since that time, we remain concerned, and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed. Though the worst case of a great depression has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness.

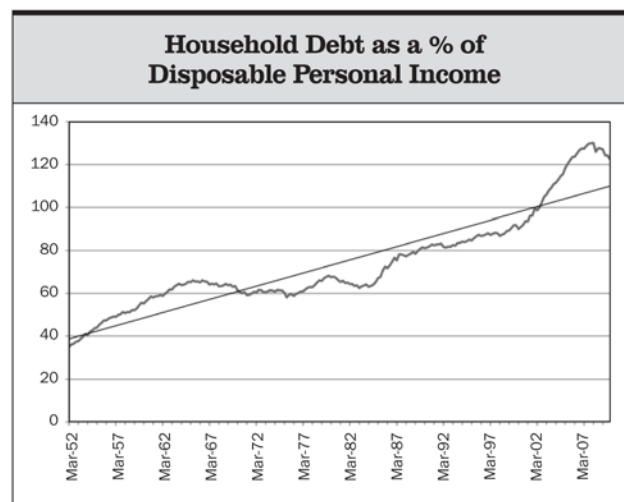
More so than in past periods, the investment climate in the years ahead will be highly influenced by how the key macro components of this environment unfold. We’ve seen massive growth in debt throughout society, reaching binge levels in the last decade. Think of all that debt as a form of borrowing against

future consumption – now we must pay it back in the form of less spending. This suggests a sluggish economy, possibly for many years to come.

Government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage – including the possibility that shifting gears to cut budget deficits too early could throw the economy into another decline.

The recent economic strength stems mostly from this stimulus spending and smaller inventory drawdowns (companies are still drawing down inventories – selling more than they are producing so that inventories decline – but the drawdown has slowed). The problem is that both of these factors are temporary.

There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will

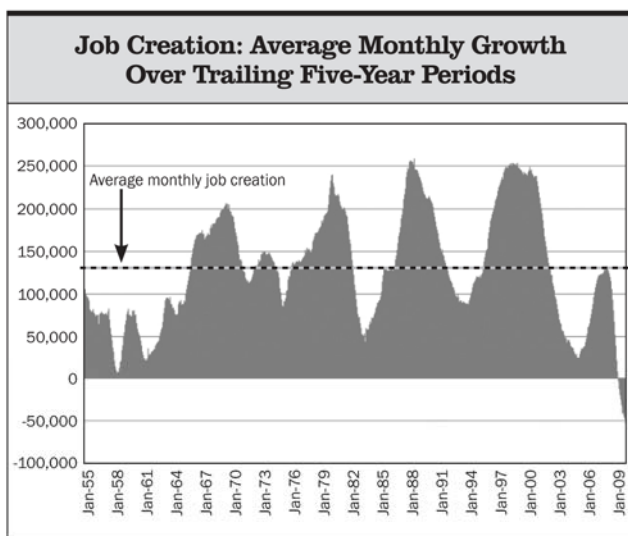


Debt is coming down, but is historically very high relative to income. Source: Federal Reserve.

pass as the year progresses. Other sectors of the economy are strengthening— manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is still fragile. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again.

In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests that a sluggish recovery is a likely outcome over the next couple of years and that there is still risk of a return to recession if government policies are not skillfully managed.

There are several important variables to a strong and sustainable economic rebound, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. But while the labor market remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation.



According to Ned Davis, if job growth averages 150,000 a month over 10 years, unemployment won't fall below 6% until 2019, or below 7% until 2018. It would break below 10% in 2013. Average monthly job growth since 1950 has been 120,000. The last 20 years, excluding the impact of the recession, job growth has averaged 137,000 per month. Source: Bureau of Labor Statistics.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests that even with a strong temporary snapback, it is unlikely we will return to a strong labor market for several years.

Other big problems include large amounts of commercial real estate debt coming due, continued strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.

The direction and health of the economy and financial markets in the coming years will depend on the resolution of these key issues. We don't know whether the positives or negatives will ultimately win out so we need to position the portfolios as best we can for either scenario.

Portfolio Positioning for the Uncertain Times Ahead

Equities: We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion. Over the

longer term, equities should also do well as investors are generally rewarded for risk over long periods of time, and we emerge from the secular bear market. The concern, however, is more with the mid-term outlook. It is possible that we will see mid-single-digit returns for stocks over the next five years, with similar returns for developed market foreign equities and slightly higher returns for emerging markets equities.

As we think about the equity markets, we also think about the potential for active managers to outperform, and we put some credence in the bottom-up views and analysis we hear from the stock pickers we respect. During these uncertain times, our managers are often able to find individual stock picking opportunities. There is some evidence that environments where overall stock returns are lower but individual company returns vary widely are favorable for active managers; we believe we could see such an environment.

Our equity portfolios remain diversified between domestic and international equities as well as across various market capitalizations. We have a slight growth versus value bias at the moment as we continue to emerge from the economic downturn. We continue to believe in the value of international investing and currently have approximately 20% of the international allocation in emerging market equities and the balance in developed markets.

Fixed Income: We have reworked the fixed income portion of our models this year, decreasing short-term bonds, increasing allocations to our core, intermediate term bonds, adding allocations to foreign and real return bonds, and moving high yield bonds back to our fixed income sector. The foreign bonds include both developed market bonds for all portfolios as well as emerging-markets local-currency bonds in larger accounts. The returns are driven by the underlying bond yields plus an expectation of at least mild

currency appreciation given the stronger fiscal conditions in much of the developing world. In 2009, we added high yield bonds into the portfolios as they had better potential than stocks in almost every scenario, and much less risk. This move worked out well as high yield bonds produced big returns last year. High yield has continued to do well in 2010, though the returns have been much more moderate. We have now moved these funds from the equity sector back to the fixed income sector and will continue to have an allocation to them, although we are trimming the positions to take some profit now that their prices have increased. We have also added an allocation to real return bonds, or Treasury Inflation Protected Securities, to build some inflation hedges into the portfolios.

Diversifying Strategies/Real Assets: As outlined in the January cover letter and newsletter, we are in the process of moving a portion of the equity allocations to diversifying strategies and real asset funds. The core funds in the diversifying strategies sector include a long/short fund with multiple underlying managers, a market neutral fund and an absolute return fund which targets a fixed return over treasuries regardless of the market environment. In larger accounts, we are also adding in a dedicated short fund, a focused long fund, an opportunistic fund and a convertible fund. These strategies on average have outperformed the market in down markets and captured much but not all of the upside in rising markets. Because they have lower correlations with the equity markets, their addition reduces the volatility of the portfolios. The purpose of adding these funds is to protect better against future downturns, realizing that we may give up some upside in a continually rising market. We are also allocating a small percentage of the assets to real asset funds including commodities, metals and real estate. These funds also have lower correlations with the equity markets so they increase

diversification and also add inflationary hedges to the portfolios. The possibility that it may take years to complete the process of deleveraging is not uplifting. Skewing towards a more positive view when the environment doesn't support it may feel better, but is not a path to generating better returns, so we are committed to working hard to understand the reality we live in and make decisions accordingly. Our goal is to take risk where we see appropriate reward and to protect against risk when the outlook suggests that is the prudent course. As always, we thank you for 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.