

Walden Capital Newsletter

Walden Capital Advisors

Third Quarter 2010

The Great Recession may be officially over, but we continue to expect that sluggish economic growth may continue for years.

We realize this is a similar story to what we've been writing in the last few quarters, and it's not necessarily encouraging. However, it's not all gloom and doom either. In the scenario we think is most likely, the economy continues to grind ahead slowly as we work through the aftermath of the recent crisis. While we think it will take years to work through all of the housing, debt, and job market issues, at least we are on that track.

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Quarterly Investment Commentary

The stock market continued its roller coaster ride in the third quarter, with strong September gains bringing returns solidly into the black for the full quarter. The large-cap S & P 500 Index is up 11.3% for the third quarter, yet just 3.9% for the year. Small and mid-cap stocks have outperformed large-caps, posting year-to-date gains of 9.1% and 11.0%, respectively. Foreign stocks had a very strong quarter, with the MSCI EAFE Index up 16.5%, bringing the year-to-date gain to 1.1%, while the MSCI Emerging Markets Index gained 18.0% for the third quarter and is up 10.8% for the year. On the bond side, the Barcap Aggregate Bond Index posted a solid 2.5% gain for the quarter and is up nearly 8% for the year to date. Emerging-markets local currency bonds climbed roughly 6% in the quarter and have gained about 16% so far in 2010.

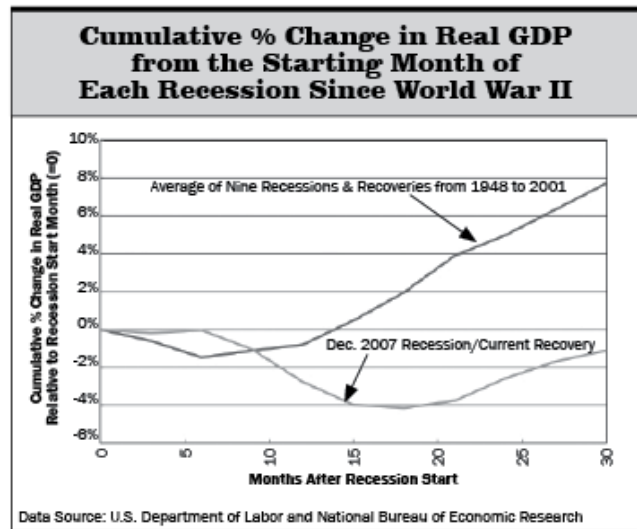
Economic Outlook

The National Bureau of Economic Research recently announced that the Great Recession officially ended in June 2009—marking the country's longest and deepest recession since the 1930s—but our big-picture view of the economic environment in the United States remains cautious and is largely unchanged from what we have been describing over the past year. We continue to believe we are in for a sustained period of subpar economic growth as a consequence of the financial crisis of 2008 and its aftermath. Ongoing "structural" headwinds such as consumer deleveraging, high levels of unemployment and underemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes, and cuts in local, state, and federal government spending in response to their financial difficulties all imply that aggregate demand, and ultimately corporate revenues and earnings growth, are likely to be under pressure for a while. In short, this is not your typical post-WWII business cycle.

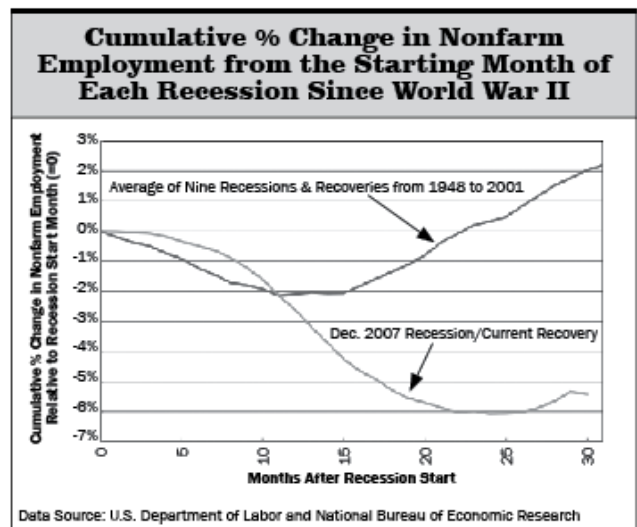
With regard to deleveraging, households have started to make progress reducing debt toward sustainable levels—although they still have a considerable way to go—but federal government debt has ballooned.

In the second quarter, household debt contracted by \$57 billion (a 2.3% annual rate), marking the ninth consecutive quarterly decline. State and local government debt also declined slightly in the second quarter after five consecutive quarterly increases. However, growth in federal government debt continued to soar, at an annual rate of 24%. Over the medium to longer term, there is a great deal of uncertainty about the ultimate resolution of the growing government debt problem. But even in the near term, there remain serious questions about the sustainability of the current (weak) economic recovery as the short-term boost from business inventory restocking ends and the \$800 billion federal stimulus program winds down. After spiking to a 5% growth rate in the fourth quarter of 2009, real GDP growth dropped to just a 1.6% annualized rate in the second quarter of 2010. The recent economic weakness is not a surprise and is consistent with the view we expressed a year ago as the economy finally emerged from its deep downturn when we wrote, "It is the expectation of slow consumer spending growth coupled with increasing regulation and likely reduced risk taking on the part of businesses and investors (relative to much of the past 20 years) that suggests that any near-term burst of economic activity will be hard to sustain at a robust level."

Exacerbating the economic uncertainty is the significant political uncertainty and risk of policy errors. Most pronounced is the tension between those who argue for fiscal austerity now in order to start addressing our deficit and debt problem, and those who argue that more government stimulus is needed to get the economy out of its current rut. On the one hand, if the creditors who are lending to the U.S. government at the current very low interest rates (2.5% for a 10-year Treasury note) start to lose faith in the credibility and credit-worthiness of the United States and/or the dollar, that could lead to a sharp rise in interest rates, which would not be good for the economy. Fifty percent of Treasuries are held by foreigners, with China and Japan each



GDP data through June 2010.



Employment data through June 2010.

accounting for 10% of the total. On the other hand, a premature move towards fiscal restraint—before the economy is in a self-sustaining growth mode—could tip the economy back into recession or worse, as economic historians argue was the cause of the second down-leg of the Great Depression in 1937.

We realize this is a similar story to what we've been writing in the last few quarters, and it's not necessarily encouraging. However, it's not all gloom and doom either. To be balanced, there are some positive economic signs. Industrial production and earnings have rebounded strongly.

Profitability is high (due to aggressive cost cutting during the recession) and companies also have very high levels of cash on their balance sheets. (However, it should be noted that corporate debt levels are also very high, as companies have opportunistically issued long-term debt and held much of the proceeds in cash.) The personal savings rate rose to 6.1% in the second quarter, which, while not helpful for near-term economic growth is necessary for the longer-term healing of the economy. Interest rates remain low and relatively stable. (But low rates also reflect the risk of deflation and even the Federal Reserve recently stated that inflation is currently “somewhat below” its target range.) Developing economies continue their high rate of growth (the IMF forecasts they will grow 6.5% next year versus 2.5% for the developed world) and have relatively strong fiscal/debt balances, which should drive growth in emerging-market demand for U.S. exports.

Sector Outlook

Meanwhile, investment opportunities are more a function of price than of the overall economic story. It is important to evaluate the potential risk versus potential reward for the various alternatives when allocating a portfolio among different asset classes.

Equities/Diversifying Strategies – Many experts are predicting lower than historical returns for equities over the next few years. While we don’t consider stocks overall as cheap, many of our active equity managers, on the other hand, still report finding good opportunities at the stock-picking level. We have also heard a number of equity fund managers make the point that stocks have never been more attractive *relative to* bonds. They will typically compare the stock market’s earnings yield (the inverse of the price/earnings ratio) relative to current bond yields and note that the gap is very wide relative to historical norms. To say that stocks are likely to beat bonds over five years ignores the significantly higher downside risk

(at least over a 12-month period) of stocks versus bonds. While we’d agree that the stock market is likely to beat the bond market over the next five years, the question is whether or not investors will be adequately compensated to take on additional equity risk at current valuations.

As you are aware, this year we added some absolute-return-oriented funds (long/short, market neutral) in our portfolios. We view these as lower-risk strategies – having more downside than a core investment-grade bond fund but much lower risk than equities – that we expect will generate at least mid-single digit annualized returns over the next several years. We also expect them to have low correlations to the stock and bond markets, providing additional diversification to our portfolios. These lower-risk/lower-return strategies are particularly attractive right now given the lower than historical return expectations for stocks and bonds. It is important to remind our clients that investing a portion of the equity allocation in these funds means that if there is a strong upward move in stocks, the equity portion of the portfolios may underperform benchmarks; however, it is a more protective position if the markets decrease.

Fixed Income – Returns across the broad intermediate term, high-quality bond universe are similarly unexciting. The general consensus is that this overall asset class is unlikely to generate more than low single-digit returns in the next five years. That said, we believe the bond market is generating good investment opportunities within certain bond sectors. We have broadened our fixed income investments to include high yield, foreign, and real return and believe we can earn competitive returns at acceptable risk levels. In many of the larger portfolios, we have also added an emerging markets local currency bond fund. Current yields in these bonds are well above what we can earn in developed market bonds (including the U.S.), and their prices would further benefit if the dollar declines in the years ahead as many

expect. Additionally, many of these emerging market economies are in far better shape than those of developed countries, with trade surpluses, strong government balance sheets, and an emerging consumer class. While part of our fixed-income allocation is dedicated to these other strategies, core positions in high-quality bonds also play an important role in diversification in the event we see another downturn in the economy and stocks.

Concluding Thoughts

This may not be a typical business cycle; it is the aftermath of a financial crisis the likes of which the United States has not experienced since the 1930s. We need to consider the cycles of the past few decades as a road map for what the next five years are likely to entail but also understand that this period is different from the rest of the post-WWII U.S. economic and financial experience.

This is an environment that requires a disciplined analytical approach that is also flexible and open-minded in assessing risks and investment opportunities.

The range of potential economic outcomes is unusually wide. The multi-decade tailwind of declining interest rates for bonds is likely over, so returns from traditional bond indexes will be low. Equity index prospective returns also look lower relative to their long-term historical averages. With the potential of lower returns, it is a good time for investors to revisit their financial independence or retirement plans and make adjustments accordingly. Lower returns compounded over the next five to 10 years might push back retirement dates or require adjustments to saving and spending levels. Investors should also reevaluate and be honest about their true risk tolerance and make sure their overall portfolio allocation is consistent with that level. The experience of 2008 through 2009 provided everyone a real-world test of their ability to handle extreme risk and volatility.

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

Our Privacy Policy is enclosed with this issue of the newsletter.