

Walden Capital Newsletter

Walden Capital Advisors

First Quarter 2011

Equities performed well during the first quarter of 2011 with small- and mid-caps outperforming large-caps, growth beating value, and U.S. stocks outpacing foreign stocks. Bonds had a relatively flat quarter with the exception of emerging market bonds.

Expectations are that stock returns are likely to be lower than historical averages. Likely returns from bonds are even lower than stocks.

As a result, we have diversified our fixed income holdings and continued our commitment to the diversifying strategies asset class which is being funded from both the equity and fixed income allocations.

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Quarterly Investment Commentary

Stocks continued their upward march in the first quarter, with the large-cap S & P 500 Index gaining 5.9%, while mid- and small-cap stocks posted gains of 7.6% and 7.9%, respectively. Overseas, returns were not as strong, though still good. Developed market foreign stocks as measured by the EAFE Index were up 3.4%, while emerging market equities gained 2.1% for the quarter. Domestic high-quality intermediate-term bonds didn't fare as well, barely gaining ground in the first quarter, while foreign bonds did a bit better, with developed market government bonds gaining 0.7% and emerging market bonds climbing by almost 3%.

Stock Returns—Why We Remain Cautious

Stocks are the primary asset class for taking on risk. To understand the potential upside for stocks it's important to evaluate each of the factors that drive returns and how they might behave over our investment horizon. There are three key variables to assess: dividends, earnings growth, and changes in the price/earnings ratio.

Dividends are the excess cash from earnings paid periodically by some companies to their stockholders. Today's dividend yield is very low, so low that even strong growth in dividends paid will not make the dividend yield a huge contributor to returns over the next five years. As we write this, the S&P 500 currently yields about 1.8%. Compare this to the 25-year



Stocks have gained little ground over the past 13 years.

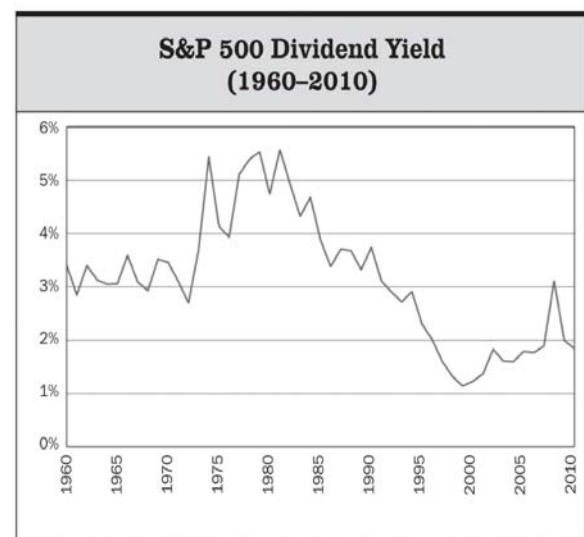


Chart 2: Dividend yields, one component of equity returns, are below their historical average.

average of 2.3% and the 50-year average of 3.1%. Bull markets in the past have always begun with higher-than-average dividend yields. Since 1926, the only time the dividend yield was lower than it is now was during the period of elevated stock valuations during the late 1990s and early 2000s. It's easier to capture strong returns over multiyear periods when more of the return comes from dividends.

Earnings growth is more challenging to assess and forecast. We start with a general premise that overall economic growth is an important driver of earnings growth.

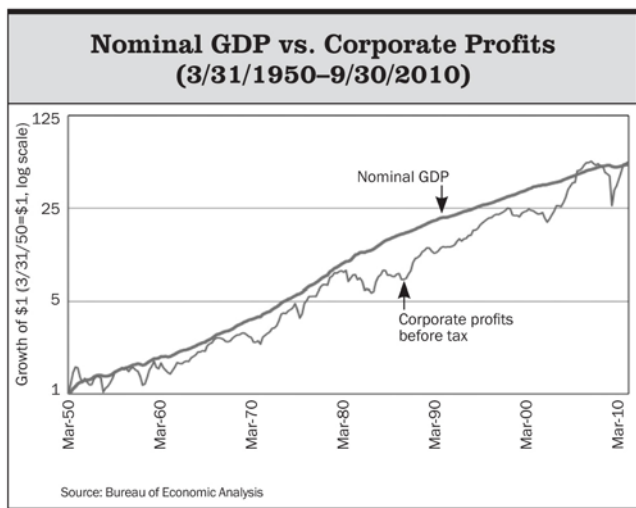


Chart 3: Earnings growth tracks GDP growth over the long term.

As chart 3 shows, over the very long term the rate of GDP growth and earnings growth has been similar, though there are shorter periods when the relationship has not held. It's also clear from the chart that earnings are much more volatile than GDP and that earnings volatility has increased over time.

Earnings have rebounded powerfully since the very deep trough in 2009. This rebound has been driven by cost cutting and government stimulus (neither of which will be sustained) and emerging markets' growth, which is likely to be sustained (though inflation in emerging markets presents a risk). Despite the sharp rebound in earnings, growth is likely to be subpar as the rest of the cycle unfolds. This is consistent with historical outcomes in the aftermath of a financial crisis. This history dovetails with a key assumption influencing the analysis—that the excessive private and public debt cloud hanging over the economy will result in continued

deleveraging and therefore a lower level of consumption than would otherwise be the case. Private debt has declined from its peak but remains historically high while public debt has spiked higher and will continue to increase given growing entitlement costs as baby boomers age.

In addition, profit margins are far above their average level of the past 30 years and tend not to stay elevated for long. This suggests that revenue growth will have to be exceptionally strong relative to expense growth in order to drive continued earnings growth. That would be a particularly impressive achievement in the face of the debt-related demand headwinds out there. Increased regulation and the likelihood of higher taxes also could challenge growth. So could unexpected economic events—such as growing instability in the Middle East (which triggered a rise in the price of oil) and Japan's tragic natural disaster, which will have a temporary impact on the global supply chain and Japan's growth rate.

Still, there are some offsetting positives. The most significant is the growth in the developing world, which is benefiting many U.S. companies. S&P 500 earnings assumptions factor in a material emerging markets impact, but it is not enough to fully offset the other macro headwinds.

Changes in the P/E multiple (the price that stocks sell at relative to their earnings) can be affected by a number of factors, including: expectations for growth, the level of interest and inflation rates, and investor sentiment. One issue to keep in mind is that investors don't like extremes of either high inflation or deflation. If they are worried about either of these, stock prices have tended to fall, taking P/Es lower. Forecasts are influenced by historical P/E ranges with attention paid to P/E levels in various types of economic and market environments. P/E assumptions range from 12x earnings to 18x earnings (P/Es based on 12-month trailing GAAP earnings have averaged about 16.5x since the end of WWII).

This all nets out to a wide annualized return range for stocks of -8% (deflation) to 11% (return to normal) with a likely return some point in the middle, below historical averages. At the low end, we believe the deflationary scenario is not likely. The economy has been improving and the developing world is growing at a healthy clip and

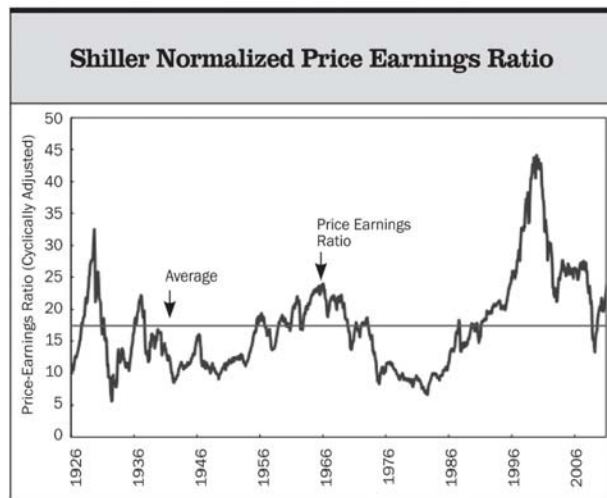


Chart 4: Except for the periods encompassing the tech and real estate/debt bubbles, the only other times the P/E has been this high was in the late 1920s and mid-1960s. Both periods preceded long and deep bear markets.

is now big enough to have a material impact on global growth. At the other end, we also don't view a quick return to normal as highly probable given the continued stress points in the economy including high public and private debt levels throughout most of the developed world, weakness in the labor market, and the threat of further declines in housing prices. Additionally there are the global risks of spiking oil prices, food and commodity-driven inflation in emerging markets, and now supply chain disruptions from Japan.

The stimulus and quantitative easing are scheduled to wind down in the coming months; it is not clear that the private sector is ready to take the baton and accelerate into a normal recovery mode. Consumer confidence is improved from its lowest levels but remains weak overall. Business confidence is back to normal levels, however, CEOs remain concerned about consumer demand. The labor market looks set to improve, but the improvement so far is at a rate that is not contributing enough to job growth (all measures of unemployment are historically quite bad—for example the U6 rate which measures the unemployed, underemployed, and "discouraged" workers is at an extremely high 16%).

Chart 5 shows how this recession was abnormally deep relative to the average (over 65 years), and how the first six quarters of the recovery have also been below average.

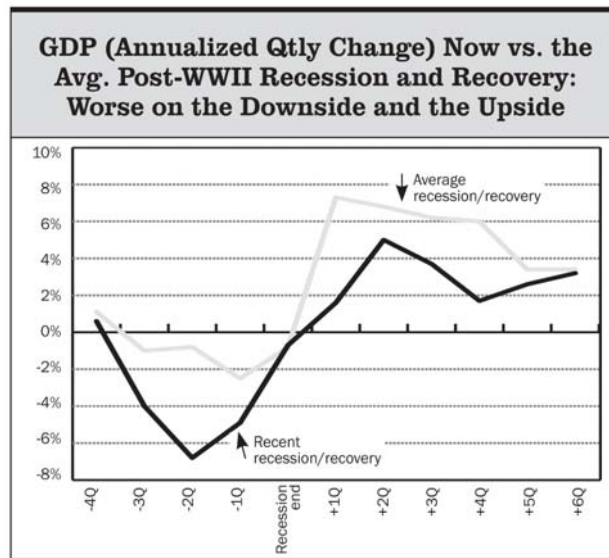


Chart 5: The last recession was unusually deep and the recovery has been below average as well.

The European equity markets remain similar to those in the United States with respect to overall fundamentals and return potential. Europe continues to struggle with its own debt crisis and economic challenges. The single currency greatly complicates policy management for a group of countries with entirely different economic fundamentals—a powerful Germany at one extreme and debt-plagued Greece, Ireland, and Portugal at the other.

It is likely that emerging market equities will generate higher returns than developed markets over the next five years but with potentially higher short-term volatility. The growing inflation risk in emerging markets has led them to underperform since late last year and is a near-term concern that we are monitoring.

Policy risk in the United States and around the world is a major concern. How high might interest rates rise and what will happen to financial markets when the Fed stops buying U.S. Treasuries at the end of QE2 in June? How will politicians address the deficit? The issue must be dealt with, but it is highly politicized and must be handled with intelligent policies and at the right pace. What is "right" is debatable but the increasing willingness of some politicians to consider tax and entitlement reform offers a little hope, though it's difficult to have much confidence in the outcome of political debates these days.

Building Intelligent Portfolios in a Highly Uncertain World

Given the level of macro risks and uncertainty facing a highly indebted developed world, our goal is to build portfolios that can perform reasonably well in most scenarios, and mitigate losses in more severe scenarios. Historically, heightened exposure to investment-grade bonds would be a natural option. However, current yields are extremely and artificially low (because of Fed policy) and we expect them to be higher over the next few years. Traditional fixed income returns are expected to be in the low single digits. As such, over the past year we have diversified our fixed income holdings to include floating rate loan, real return bond, foreign bond, and emerging markets local currency bond funds. The floating rate loan funds invest in bank loans that have adjustable interest rates. Effectively this means that they should experience minimal price risk due to changes in interest rates. Real return bonds are in the portfolios because we expect inflation to rise over time.

The foreign bond fund invests primarily in developed market government debt and has stayed away from some of the less stable European countries. Emerging markets local currency bonds are currently yielding around 7% and it is likely that the dollar will gradually weaken relative to the currencies owned in the fund. Analysts expect these bonds to return in the high single digits over the next five years. Please note, however, that while the expected returns from these asset classes are higher than others, they are also more volatile and have the potential for greater short-term declines along the way.

Our diversifying strategies sector continues to invest in a group of funds with lower correlations to the market. The goal of this strategy is to protect the portfolios more in a down market. As 60% of these assets are taken from the equity allocation, the portfolios may underperform in a rising market, as occurred this past quarter. This is a tradeoff we are willing to make. As reported last quarter, 40% of the diversifying strategies sector is now pulled from the fixed income allocation with one of the new funds being an actively managed long/short fixed income fund which aims to neutralize duration and reduce interest rate risk.

Conclusion

The Middle East uprisings and the horrific Japanese earthquake, tsunami, and nuclear disaster were entirely unexpected. Oil prices are higher than they would have been and, as we write this, it is not entirely clear what the short-term global economic impact of Japan's disaster will be. Regarding oil, up to this point the price spike is one the global economy can probably absorb though it will impact growth at the margin. But there is a price point that could endanger the recovery in developed countries and cause problems for many emerging markets. Saudi Arabia is critical. For the global economy it is good that it has not experienced widespread protests and that seems unlikely. It has the wealth to placate its population. But there is still a very unpredictable element to what is happening in that part of the world. And if there is a return to recession it could trigger very nasty problems given where we already are with respect to debt, deficits, and unemployment.

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 more conservative and others when it makes sense to tilt more 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, weigh them against the risks and look for opportunities which will present themselves along the way. This discipline and longer-term focus is the core of what we add as investment advisors.

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.

Recent legislation required registered investment advisors to replace Part II of Form ADV with a newly formatted Form ADV Part 2A, a copy of which is enclosed.