



CSI CAPITAL MANAGEMENT

Investment Outlook

Winter 2010

The financial markets ended the year 2009 with another leg up as the recovery from the Great Recession continued. Once again, economic data remained generally constructive and expectations for 2010 corporate earnings continued to ratchet up, helping the market finish with a flourish. The S&P was up 6.0% on the quarter and up 68.0% from its March low.

Strength was widespread across equity markets, with large, mid- and small capitalization stocks all up nicely on the quarter and the year, though mid-cap stocks took the crown, up over 37.0% YTD. Growth stocks outperformed value stocks, 7.9% vs. 4.2%, with technology shares leading the way. U.S. stocks substantially outperformed international stocks, which were up 3.4% in the quarter. Emerging markets also continued to show strength, particularly the BRIC countries (Brazil, Russia, India and China), which were up 10.2% in the quarter and 88.8% on the year. Treasury bonds moved down firmly in price as the yield on 10-year U.S. Treasury Notes rose from 3.31% at the end of September to 3.84% on December 31.

REITs and Commodities were both up over 9.0%, but Gold fell 7.2% as the U.S. dollar rallied. As we ring in a new year and the decade of the “10’s”, we still face significant crosswinds, both financial and political. In this Outlook, we attempt to look back at the events of the last decade with the hope of gleaning some important lessons.

Lessons Learned

The financial markets finished 2009 with a well deserved respite from the turmoil that began the year. The Housing Crisis, the Banking Crisis, the Great Recession, the Financial Market meltdown — all appear to be behind us. Nevertheless, the markets remain well below their high water marks and offer little encouragement towards being able to attain their prior heights anytime soon. Presently, we are struck by the profound nature of our economic challenges and the wide array of possible outcomes that may result. These are reflected in the exceptionally divergent opinions that

are currently running through the financial press and academic blogs. The opinions of well-credentialed and highly regarded pundits, be they investors, strategists, economists or academics, vary widely regarding such issues as inflation, deficits, the dollar, the outlook for growth, whether the stock market is rich or cheap, the next bubble, the direction of interest rates, the need for additional stimulus and so on. Serious economic imbalances, like our low savings rate and high deficits, do remain and it is anyone’s guess as to how they will be resolved. Fortunately, the markets have already discounted some of the nastier scenarios, leaving investors with ample selective opportunities.

A few of the more erudite economists we follow maintain that the large correction we have just been through is unlikely to be repeated anytime soon. Rather, they make the case for more truncated business cycles with frequent, shallow contractions. Given the amount of deleveraging that has already occurred in the financial system, in combination with the increased sensitivity to policy decisions, both fiscal and monetary, we favor this view. Perhaps the only thing we can say with certainty is that the road ahead will entail its fair share of risk.

As we reflect back on the past decade and ponder the future, we would like to review ten valuable lessons that were reinforced over the last two years.

Lessons 1 - It is Hard to Find Where You’re Going if You are Always Looking Backwards

Financial companies, high yield debt, REITs, emerging markets are hardly the most favored assets to buy in the midst of the worst financial crisis in almost a century. Yet these are the very asset classes that provided investors with the largest returns since last March when the market bottomed. There are several reasons why the most feared asset classes tend to be the ones that have historically provided for the greatest rewards once a market turns. Many of these reasons are behavioral in nature and, not surprisingly, there has been a recent resurgence in this field of finance. Investors also tend

to extrapolate current trends too far into the future. The famed investor George Soros, for example, made this tendency a cornerstone of his investing strategy.

Take Away: Successful investing requires a disciplined approach with a view to the future, an appreciation of the past, and an acceptance of the present.

Lesson 2 - The Range of “What’s Likely” is Bigger than We Think

Most of the models used in finance today are built on the assumption that while the future is not known, there exists a range of possible outcomes. The probability of each of these possible outcomes drives prices in the marketplace. Despite decades of experience and arguably brilliant minds being put to the task, the market seems to be consistently surprised at what eventually transpires. Each decade continues to bring us a number of events that, according to the models, have less than a one in 3.5 million chance of occurring.

Take Away: Overreliance on financial models can lead to ruinous consequences.

Lesson 3 - Financial Planning and Investing, Like Life, Involve Trade-Offs That May Not Play Out As Planned

Many things in life involve trade-offs. E.B. White once wrote: “I arise in the morning torn between a desire to improve the world and a desire to enjoy the world. This makes it hard to plan the day.” For the financial planner, the decision of what to spend and what to save is critical. Save too much and you could end up giving it all away; spend too much and you could run out of funds before your time. For investors, the trade-offs center around risk and return. Taking too much risk at the wrong time might cause hard-earned savings to evaporate. No matter what the trade-offs are and regardless of how much we may feel we understand them, life has a way of keeping us on our toes.

Take Away: Accept life’s challenges. Plan for the worst, but be flexible enough to take advantage of opportunities as they come your way

Lesson 4 -Excess Leverage Always Ends Badly (or what does it take to get a ‘Great’ in front of your name)

Looking back at history, a common theme in the largest of our financial corrections was the presence of excess

leverage. In the Stock Market Crash of 1929 and subsequent Great Depression of the 1930’s, it was excess margin used to purchase stocks that led to calamitous results. In the more recent Great Recession, it was excess mortgage debt and financial leverage used by hedge funds, investment banks and the derivatives market that led to dire consequences. Excess leverage allows assets to exceed their intrinsic value and financial bubbles to develop. It also creates the necessary conditions for debt deflation, a highly destabilizing economic state. From an investing perspective, markets tend to perform quite well as the excess leverage is being established, but subsequently perform exceedingly poorly as leverage normalizes.

Take Away: It is best to tread carefully when bubbles are afoot.

Lesson 5 -Long-Term Means Really Long-Term

During the lows of the bear market in March of last year, market commentators were quick to point out that bonds had outperformed stocks over the past 40 years. (Of course, from that point stocks took off on a nearly 70% tear over the remainder of the year while bonds languished.) Dramatic swings in the market aside, studies have concluded that in order to have a high degree of confidence that stocks will outperform bonds, a period as long as 40 years is required. When we shorten the time frame to a mere 20 years, there is only a 75% probability that stocks will do better than bonds. Of course, one’s starting point is critical. It is not uncommon for stocks to have a decade or more of tepid performance after a strong bull market. Likewise, it is difficult for bonds to produce meaningful returns when long rates are starting out near 3.0%.

Take Away: If you’re old enough to save, you’re old enough not to put all your money at risk.

Lessons 6 -Fundamentals are Key - But Not Always Visible

Fundamentals are the basic economic, financial, and operating factors that influence the success of a business and the price of its securities. One of our core investment beliefs is that fundamentals should drive the investment decision. The practical application of this belief is that valuation matters. To put it another way, one should always be skeptical of markets whose movements are driven more by recent changes in price rather than the underlying factors that determine value. The challenge then becomes to identify and understand

these factors. This is easier said than done. For example, if the market had been more aware of the excessive levels of financial leverage, and the vast number of mortgage loans based on fraudulent representations and the diminutive amount of analysis done by ratings agencies, then we may have avoided such a gut-wrenching correction.

Take Away: Market corrections often become evident only in hindsight.

Lesson 7 - Markets Overshoot

“The best returns are when things go from awful to merely bad.” – Ken Leech

Markets have a way of “overshooting” both when they rise and when they fall. The largest movements, both positive and negative, occur at turning points. This is because not only do the markets have to travel through the change in the fundamentals, they also have to travel through their “overshoot.”

Take Away: Do not expect a repeat of the last nine months.

Lesson 8 - A Raging Bull Market or a Precipitous Bear Market Tend to make People Reactionary

There is an old adage that floats around the financial markets: “Don’t confuse brains with a bull market.” Behind this saying is the notion that it doesn’t take much skill to profit from risk-taking, just a rising market. In bear markets, the mantra changes to avoiding risk altogether even to the point of throwing out risk-based models that were decades in the making.

Investing intelligently is all about taking intelligent risks. We do not believe anyone is so prescient that they know when to be in and out of markets. Once we accept that to be an investor means you’re “along for the ride,” we start to look for ways to improve the experience. We believe that we can add value, through good markets and bad, by taking risk intelligently. This doesn’t mean re-inventing models that have stood the test of time. But it does require patience to give the models the time they need to work.

Take Away: When a model’s beauty is that it works in the long-run, don’t abandon it in the short-run.

Lesson 9 -Learning to Live with Less (return or things) may be the Real Road to Happiness

How many of us know someone with a highly concentrated, high risk portfolio whose mood goes up and down with the rise and fall of the market? How many of us know someone who has spent too much and now finds himself long on debt and light on savings? How many of us are glad we weren’t one of those people over the last twelve months? When compared to those who have lived well within their means and been satisfied with more consistent, yet lower, returns from the markets, the biggest difference we notice is a sense of contentment.

Take Away: Be happy with what you have.

Lesson 10 -Policy Makers Tend to be Myopic

Our policy makers have an affinity for quick, short-term solutions. Perhaps it is the influence of our election cycles and increasing contentiousness between our politicians. Perhaps it is the media’s tendency to sensationalize. Whatever the cause, we seem to demand immediate and painless solutions to what ails us. Elected officials find it hard to take the long view, even when clearly in our best interest. By settling for the short-term fix, it is unclear if we are accomplishing anything more than pushing our problems a little further down the road.

By contrast, in the late 1970’s, then Federal Reserve Chairman Paul Volker pushed short-term interest rates to punitive levels to combat rising inflation. By March of 1980, short-term rates topped 20% and the S&P was trading at 102. What followed was three years of pain. Afterwards, the economy experienced 25 years of growth punctuated by only two minor recessions and a bull market in equities that lasted for nearly 17 years and saw the S&P grow to 1500, a return (including dividends) of over 2,000%. By taking the long view and accepting three very difficult years, Mr. Volker helped usher in decades of economic and market prosperity.

Take Away: It pays to take the time to do a job right.

Hopefully, these lessons will help all of us achieve a truly healthy, happy and prosperous new year.

Roth IRA Conversions in 2010

The year 2010 brings a significant change in the tax laws that allows just about anyone the opportunity convert a traditional IRA into a Roth IRA. Whether such conversions will benefit anyone (besides the Government) has been the topic of numerous articles and vigorous debate. Suffice it to say, this is a very complicated issue and one that involves the analysis of many variables, most of which need to be estimated. When all is said and done, we accept that the vast majority of us will be best served by leaving our funds in a traditional IRA. Fortunately for us, we have our own in-house expert, Dave Hudson, CFP®, to help determine whether it make sense for you to convert.

The decision on whether to convert or not can also be a costly one. If you decide to convert, the converted funds will be treated as ordinary income on top of your existing income, and potentially be taxed at a higher marginal rate. There are, however, a few simple questions we can ask to see if a conversion is even worth consideration. First, a simple review of what a Roth IRA is and how it differs from a traditional IRA is in order.

Roth IRAs are tax deferred accounts in which earnings can both grow and be withdrawn tax free. This differs from a traditional IRA, where distributions are taxed as ordinary income. Since nothing comes for free from the IRS, Roth contributions can only be made with after-tax money. This differs from a traditional IRA where contributions can be made with pre-tax dollars. There are also no required minimum distributions (RMDs) from a Roth IRA, unlike traditional IRAs, where RMDs are mandatory after age 70 ½. As the law stands today,

contributions to a Roth IRA can only be made if your income is below \$177,000 for joint filers and \$120,000 for single filers.

So which type of account is better for you? You might be quick to say a Roth IRA because you can both grow money and withdraw it tax free. However, if you are in a high tax bracket today, and expect to be in a lower bracket tomorrow, as is the case for many of us who do not plan to work until the day we die, the current tax deduction may make a traditional IRA the preferred alternative. In fact, we find that the most important factor in determining whether or not to invest in, or convert to, either a Roth or traditional IRA is where your future individual income tax rates will be as compared to where they are now.

Evaluating whether or not a Roth conversion makes sense for you can be a difficult task. Income and estate tax rates are currently in flux and Washington may change the rules of the game at any time. A close look at your personal situation is necessary to make the right decision. In general, if you have outside funds to pay for the conversion tax, expect your income tax rates to remain high through your lifetime and expect you will not need to spend down your retirement assets throughout your life, then a conversion may make sense. If not, it may be better just to stay put. Whatever your situation, we are here as a resource for you. If you think you might be in a situation to benefit from a conversion to a Roth IRA in 2010, please give us a call and we would be happy to help you with your decision.

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