AVATAR
ASSOCIATES

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The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

At time when there is some evidence that the economy has entered a phase of self-sustaining expansion, corporate profits for the first quarter are likely to add to this perception of strength. Importantly, the growth in earnings is coming largely from manufacturing and industrial processors, unlike the last two economic recoveries. In the early 1990s and again after the 2000 recession, finance and the consumer were the lead sectors. Even as the country continues to import goods at a strong pace, exports have also grown very strongly. As developing countries gradually move toward a more consumer-centric model and away from export specialization, it is probable that the trends in U.S. exports and manufacturing will continue to be very healthy. Overall profits may begin to slow somewhat in a few quarters, however, as the financial sector continues to struggle to find replacements for proprietary trading and financial derivatives which had inflated their results. For our money, the current mix of profits is of a higher quality and more sustainable now that financial services have receded in importance.

Our Practical Value model is recording a continued willingness for investors to place higher valuations on equities. We measure that in a number of practical ways, including tracking the extent to which corporate insiders express their confidence in their own companies. Insider buying continues to rise. As we have mentioned on other occasions, business executives are also increasing the pace of capital spending, dividend increases and share buybacks. All of these reflect the possibility that valuation levels can expand from here. Investor attitudes, which moderated somewhat during March, seem to be getting more positive. For now, these attitudes do not appear unsustainable to us. Finally, mutual fund investors have stepped up a little their exposure to equities. Again, this appears to be in a relatively early stage and therefore not yet a concern that it might be overdone.

Our Economic Liquidity model improved during the month, primarily as long-term Treasury rates moderated, as investors feared the combination of political turmoil in the Middle East and the horrible consequences of the disaster in Japan would harm global economic growth. Our concern, though, is that should that growth continue and, as hinted in the U.S. employment report for March, even accelerate, then the pressure on central banks to raise rates will increase. In the early days of monetary tightening, equity markets tend to focus more on the growth in profits and the economy. If history is a guide, then later on in the process, concerns will increase that rising rates could push back at growth. That is particularly when it pays not to "fight the Fed." For now, we judge that risk as moderately low.

Our Momentum model regained its strength toward the end of March. Smaller capitalization stocks continue to outperform the larger-cap group and that is historically a sign of good internal market conditions. On the minus side, cyclical stocks corrected a bit more than did the more defensive stocks. Volume has continued to be on the low side. However, given how many different venues at which stocks are now traded, there is less confidence that all the trading is being measured properly. The percentage of trades accounted for by large blocks of stocks continues to decline. In its place, so-called "algorithmic," electronic and high frequency trading has changed the fundamental face of the exchanges. Historically, trading volume has not been one of our more important indicators. So our response to these major changes is to treat the data even more carefully.

Our Bond model improved just a little, but is still cautious towards Treasuries. Credit conditions continue to improve so the fundamentals for the corporate sector are still bullish. On the other hand, as the day approaches when the Federal Reserve moves to a more restrictive monetary policy, volatility in the credit sector will probably rise. In the meantime, there is a bit of a reversal in the strength of agricultural commodities which had been accelerating upward for months. There is, as well, some moderation in industrial raw materials prices. But the energy group still is rising. One result of the mixed performance of commodity prices is that bonds have moved into mostly a sideways consolidation.

EQUITY UPDATE:

The first quarter of 2011 produced the strongest quarterly returns in over a decade. The S&P 500 appreciated 5.9%, the Dow Jones Industrials 7.0%, and the Nasdaq Composite 5.0%. Most of the gains came early in the quarter.

Volatility increased in March, as the market reacted to "fat-tailed" events, or those that would beforehand be considered highly unlikely. The historic earthquake in Japan, resulting Tsunami, the threat of nuclear meltdown in Japan, and the unpredictable daily developments in the Middle East, weighed on the market. Demonstrating great resilience, the S&P 500 and Nasdaq Composite were flat for March. The Dow Jones Industrials were up 0.9%.

Small capitalization companies tend to be more local, and somewhat insulated from global calamities. As such, they outperformed larger capitalization companies in March, and in year-to-date numbers. In January and February, the market had a decidedly cyclical tilt, as stocks that were leveraged to a strengthening economy outperformed more defensive names. In March, the top performing groups were a combination of both.

Telecom services was the best sector, up 5.1% for the month, and 3.5% for the quarter. This group was heavily influenced by company-specific announcements, and speculation of merger and acquisition activity. AT&T announced a mega-merger with T-Mobile, which would result in the largest cellular subscriber base in the US. Shortly thereafter, rumors began to fly in this small sector of the S&P 500. What would happen to Sprint? Who would Verizon buy? Analysts began to talk of industry consolidation as a way for companies to increase their subscriber base, and their access to airwaves. MetroPCS Communications (PCS), and other low-end carriers, levitated on speculation that this segment was ripe for takeovers.

The second best group for 2010, the first quarter of 2011, and in March was the industrials sector, up 1.7% for the month, and 8.2% for the quarter. The group's continued strong performance was broad-based. Industrials are benefitting from better-than-expected economic growth in the US, the perception that China will continue to grow at a rapid pace, and from potential new business resulting from a re-building effort in Japan. We continue to be overweight here.

Coming in third was healthcare, up 1.7% for the month, and 4.9% for the quarter. The top stock in the group, Cephalon Inc. (CEPH), received an unsolicited take-over bid and rallied 34.5% in March . Many of the best performers were bio-tech companies. They are potential acquisitions for big pharmaceutical companies, which desperately need to acquire potential new drugs for their pipelines.

The fourth sector was materials, up 1.68%.in March, and 4.0% year-to-date. Materials were weak the first half of the month, and then recovered on expectations of re-building in Japan, and a resurgence of growth in emerging markets, especially China. Chemicals, as in February, were the leaders in the group. We continue to overweight materials.

Energy was the best sector in the first quarter, up 16.2%, and the fifth sector in March, up 1.4%. In addition to better than expected growth in the US, and a resurgence of growth in China, these companies benefitted from the perfect storm: unrest in the Middle East, and the earthquake and tsunami in Japan. As Japan's nuclear situation worsened, other sources of energy rallied, especially coal and natural gas. To add fuel to the fire, some countries like Germany have temporarily shut down some of their nuclear facilities, and others like China are reviewing their plans for expanding nuclear energy.

Asset Allocation Highlights

Asset Class	Position
Domestic Equities	Overweight
International Equities	Overweight
Bonds	Underweight
Cash Equivalents	Neutral

Sector Over/Underweights

Sector	Position
Information Technology	Overweight
Industrials	
Consumer Discretionary	
Materials	
Energy	Neutral
Utilities	
Telecom Services	
Financials	Underweight
Health Care	
Consumer Staples	

Data as of 4/1/11

Coming in sixth was consumer staples, up 1.1%. When global shocks, such as high fuel prices related to events in the Middle East, cast doubt on economic growth, then defensive sectors tend to outperform. High yielding tobacco stocks were strong as it appeared that the FDA would not ban menthol cigarettes. Grocery stores had a good month as some announced that they would be able to pass cost increases along to consumers. Whole Foods (WFMI) announced that shoppers were loosening up their purse strings.

Utilities, another small group, was seventh, down 0.2%. This defensive group sold off during the unfolding of the nuclear crisis in Japan. Companies perceived to have any nuclear exposure, whether in Japan or not, did not perform well following the events. Once it became clear that experts were on the ground, and the situation was improving, these stocks rallied to end the quarter flat.

The eighth sector was consumer discretionary, down 0.6% for the month, and up 4.3% for the quarter. Investors were concerned that higher fuel prices would hurt consumer spending. In addition, there were concerns that consumers would be more conservative amid the uncertainty that global growth might slow due to the multitude of one-off global events, such as the earthquake. Once the situation began to improve, and investors shifted their focus to strong economic numbers, such as GDP and an improvement in unemployment, these stocks improved.

Information technology was ninth, down 2.6% for the month, and up 3.2% for the quarter. This sector was one of the most closely tied to the catastrophes in Japan, as that country is an integral part of the technology supply chain. Many components of high-tech products are produced in or near the area of the earthquake. As events unfolded, there wasn't much news regarding these factories. As it turned out, many of them had either minimal damage, or none at all, but there was concern that they would be shut down due to a lack of power because of the nuclear meltdown. As companies move forward, it appears that many have been able to find substitute materials or relocate manufacturing as needed.

Performing last was the financial sector, down 2.6% for the month, and up 2.7% for the quarter. These stocks rallied early in the quarter in anticipation of positive results from the Federal Reserve's new round of stress tests. The hope was that the large institutions in the group would be healthy enough to raise their dividends. The result, however, was a classic case of "buy the rumors, sell the news": once the announcements were made, it was clear that this sector continues to have long-term secular headwinds and unresolved issues. We continue to underweight financials.

As we ponder the data, and watch this market, we will approach the task of portfolio management as we always do: with a thoughtful implementation that is well-diversified and pays close attention to the risks we see in the marketplace.

FIXED INCOME UPDATE:

A threshold of sorts appears to have been crossed with the release of the March employment statistics. That report suggests that the U.S. economy, which by the fourth quarter of 2010 already had exceeded its prior peak (2007), both in nominal and inflation-adjusted terms, has in the first quarter of 2011 begun a self-sustaining phase. In its simplest terms this a process where employment growth leads to income growth, then consumption growth, then production growth, and back again to employment growth.

The fact that the pace of this growth is, perhaps, not so strong, does not change the importance of reaching this milestone of a durable expansion. That there are headwinds to growth is obvious. Banks, both here and, especially, in Europe, still have tons of bad debts to deal with. The global economy is dealing with a nasty bout of commodity inflation which brings much more pain to the less mature economies where basic necessities take up a much larger portion of household budgets. Political uprisings and natural disasters also make the continuation of ordinary business that much more difficult. Nonetheless, an economy in expansion has a much stronger chance of absorbing shocks of these natures than one just bumping along a bottom.

We sense that the degree of economic growth is, for now, less important than the fact of growth. The reason is that a large group of analysts and economists (perhaps a majority) still expects the economy to ultimately fall back in response to the challenges cited above. To the extent that a durable expansion gradually reduces the number of skeptics, a new set of factors come to the front. Namely, if the economy is no longer in peril, then monetary policy in particular seems out of step. The chairman of the Federal Reserve Bank, Ben Bernanke, has made it abundantly clear that there are so many remaining doubts about the economy that the "emergency" that was declared in 2008 still is in force. Eventually, however, that declaration would need to be rescinded if the economy proves hardy enough to grow in the face of the headwinds.

While there are few times when it can be said that the economy is in a "normal" state, when it is, the Fed usually pegs short-term interest rates near the inflation rate. Right now the "emergency" has dictated rates of less than 20-basis points. The inflation rate is about ten times that level, or 2%. At some point the Fed would seem to need to also be back to a normal policy (one that has a rough balance between inflationary growth and deflationary contraction).

The current complication to all of this, as if one was needed, has been the rise in the global inflation rate, largely reflecting commodity spikes, even if they turn out to be transitory. When the Fed does get around to raising short-term rates back to normal levels, the prevailing inflation rate will have a major impact on how the rest of the interest rate cycle plays out. If inflation is still under control, then long-term rates will not rise too much, if at all, from current levels even as short rates rise.

We continue to believe that the Fed has played an important role in perpetuating this uncertainty by not being precise enough in its intentions. As evidence mounts that the economy has reached escape velocity, the Fed may sense it has painted itself into a corner.

This kind of uncertainty is not good for fixed income investors. With evident strength in the private sector, corporate bonds should perform better than Treasuries. Even so, volatility could rise for corporates in sympathy or in confusion. For now, however, we continue to deemphasize the government segment of the bond market.

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Investment Philosophy:

1) Avatar believes that a portfolio's stock/bond/cash mix has the greatest impact on risk and performance.
2) Avatar employs quantitative, top-down, macro-economic models in its decision-making process.
3) Avatar uses a disciplined and flexible asset allocation approach designed to generate solid returns by reducing the perils of volatility.
4) Avatar implements its quantitative discipline according to the clients' needs, utilizing futures, ETFs, stocks, bonds, and mutual funds.

Avatar Associates specializes in tactical asset allocation and manages approximately $1.075 billion in assets. Clients include institutions, wrap brokerage sponsors, financial planners, and private clients. Product offerings include overlay, sector rotation, fixed-income, defensive equity and core equity. Avatar Associates employs a quantitative, top-down, macro-economic model, refined qualitatively by a seasoned research and portfolio management team. For more information about Avatar Associates, please visit www.avatar-associates.com.