

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

Recent equity market advances are confirming, largely, a view we have held that as the economy begins to give evidence of having reached a self-reinforcing growth phase, investors will start to get more interested in individual companies and less worried about the overall level of the market. That is, we move from a "stock market" more to a "market of stocks." This event leaves a bit of a trail that we monitor. For example, the average correlation between stocks tends to fall. The breadth of valuations of prospective earnings starts to widen. Stock selection techniques begin to have more traction. The percentage of trading volume accounted for by market and sector ETFs tends to recede. At the moment, these kinds of monitors are suggesting the market is rendering a decision that confirms a better economic and investment outlook. Given the still-cautious outlook of the consensus that we will experience below normal economic growth, there is a fair amount of risk that one side or the other will be "disappointed" in that their portfolios are wrongly positioned. Until one side or the other gets the upper hand by virtue of the facts, there will be a noisy stock market environment, subject to periodic rallies and corrections within a fairly lengthy period of "transition" that seems to characterize 2010.

Our **Practical Value model** continues its mixed message, resulting in a neutral reading. Opinion surveys are slightly less enthusiastic, echoing an even more cautious view from individual investors. That group has been looking back at the crash of 2008 and keeping relatively low exposure to equities and high exposure to conservative bonds. Corporate insiders are also giving mixed signals. As the stock market rises, some insider selling appears, but not in strong numbers. Market valuations are also in the neutral zone. By some measures, investors are counting on continued rapid growth in profits. Clearly, if the economy experiences a significant new slowdown,

then these valuations will have been too high. On the positive side, the consensus view of the economy is, indeed, only grudgingly upbeat. Stocks are quick to react to any hint that the economic recovery is faltering.

Our **Economic Liquidity model** deteriorated a bit. Even with continued surprising strength in the dollar, the fixed income markets are clearly getting more unsettled. So while the issue about the future credit standing of the U.S. is in the financial press, there is no flight of capital out of the country. Nor is the inflation rate or measured expectations of that rate creeping higher. By process of elimination, bond traders are laboring under huge new supply of Treasuries as the record budget deficit needs to get financed. Fortunately, corporate credit conditions continue to brighten. Thus, our policy continues to favor these bonds.

Our **Momentum model** is, generally, hovering at the higher levels signifying above average conditions. The broad indices are trading at the highest levels since the crash. There is a confirmation from the breadth of the markets' advance-decline indices. Small- and mid-cap stocks are as strong as their bigger cousins. There is a slight indication that the rate of the advance is slowing and there are a few nits to pick under the surface. Volume continues its pattern of the last years and is very low. This translates into "money flow" that, while showing a net positive direction is still a long way from a healthy long-term reading.

Our **Bond model** continues its split reading: generally cautious on Treasuries and generally positive on corporate credits. Much of this characterization owes to the relative supply of each. The size of the Treasury auctions continues to set records, while corporate profits are so strong that their cash positions allow them a period of relatively low net new bond issuance. On the horizon are some hints that recent accelerating tax

collections can take a bit of the pressure off the Treasury. On the other hand, a strong economy will

eventually require companies to go to the bond market for funds.

EQUITY UPDATE:

The major indices moved up nicely (again) for March. As noted last month, there is still a mighty struggle between micro-and macro-issues (as in one getting better and one headed generally in the wrong direction). We will now begin the first quarter earnings season, starting with Alcoa on the 12th of April. Earnings are expected to increase by approximately 30% from last year. Interestingly, since the operating environment is very good for banks currently, the growth number “ex-financials”, which has been a popular way to view earnings since the market meltdown, is expected to come in only 25% higher than a year ago. While these numbers appear to be excellent, the collapse in earnings was so pronounced that we are still approximately 38% below the peak in earnings seen in 2007 on a 12-month trailing operating earnings basis.

For the year, “growth” names have outperformed “value” names, though for March, in both small-capitalization and large-capitalization names (not mid-sized), growth stocks outperformed. Also, in terms of performance factors that we and many others track (both momentum and valuation), there was very little help in March. It was, as were many of the months over the last year, an “upside down” month for factor work—in other words, things that would intuitively be expected to predict one behavior actually worked in an opposite fashion. For example, companies which experienced upward revisions in their earnings actually went down in price for the month. In fact, one of the only positive factors was industry momentum.

The sector performance for the month was decidedly cyclical in nature. The top five groups included industrials, financials, consumer discretionary, materials and technology. The bottom five included telecom services, consumer staples, energy, healthcare and utilities. The industrials group was also the best performer in the first quarter, after being the second worst group for 2009. (Financials were the worst in 2009.)

The financials were the second-best performing group in March. For the first time in two years, our SectorStrength model has ranked this sector a buy. As mentioned above, the operating environment for this group could not be better. As for assets on the balance sheet, these companies have been allowed to kick the can down the road. We are still long-term bears for this sector, but it has been performing well lately. This good performance comes after turning in the worst performance of any sector for 2008 and 2009. The 2009 performance included top spots in the second and third quarters of last year, and bottom spots in the first and last quarters.

Consumer discretionary stocks continue to do well, coming in third for both March and the first quarter overall. These stocks have performed well during the rebound, particularly in the two most recent quarters. Since so much of the economy is dependent upon consumer spending, investors have cheered the good results here.

Asset Allocation Highlights		
Asset Class	Position	
Domestic Equities	Underweight	
International Equities	Neutral	
Bonds	Neutral	
Cash Equivalents	Overweight	
Domestic Sector Ranks		
Rank	Sector	S&P 500
1	Materials	3.51%
2	Consumer Discretio	10.11%
3	Financials	16.54%
4	Industrials	10.47%
5	Health Care	12.13%
6	Information Techno	18.75%
7	Energy	10.98%
8	Consumer Staples	11.23%
9	Telecommunication	2.81%
10	Utilities	3.47%
		100.00%

Data as of 4/1/10

Next on the list was the materials sector. Like the discretionary group, this group has performed well, as would be expected, as the market has rebounded. Of its components, about half are chemicals, about one-third are metals and mining, and the balance are construction materials and paper and forest products companies. During the downturn, this group was hit hard and many companies lost anywhere from 70% to 90% of their value. As stocks have rebounded, most of these companies have doubled or tripled.

Technology, the 5th best group for the month, has been lagging on a relative basis after leading the pack in 2009. Windows 7 has proven to be a solid product, Apple's iPad has launched to good reviews, and as the economy recovers, this group should remain an attractive area of growth. We remain overweight in this area.

Telecom services, the sixth best performer for March, is near the bottom of our ranks. It has been the worst performer for the quarter. This group has simply not kept up in the upturn, after falling as much as other groups in the downturn.

Consumer staples have lagged due to the fact that they didn't fall as much in the downturn, and therefore didn't have as far to go in the upturn. In sharp contrast to companies in other sectors, many of the staples companies saw a slowing, but no downturn in earnings

FIXED INCOME UPDATE:

One of the most important events during the Great Recession was the aggressive way that businesses around the world focused on reducing inventories. Because the supply chain for goods is so finely tuned, the world experienced the equivalent of a 80-car pileup on a foggy stretch of highway. We know now that demand for final products, in fact, did not decline as much as production was cut in response.

But even with almost a year of evidence that product demand has stabilized and actually increased, businesses have continued to take a very cautious approach to inventory management. Part of the measured growth of GDP over the last few quarters, to

over the last two years. This sector ranks poorly in our SectorStrength model and we are currently underweight the group.

Energy prices continue to rally, but the break-out in prices has only been recent and it remains to be seen where they go from here. The biggest player, Exxon, has lagged due to a shift to "long plateau assets" in potentially less profitable projects. If, however, world economies continue to improve, oil prices, and therefore stock prices in this group will continue to move up. We are slightly underweight this group and will await a better entry point.

Healthcare stocks, coming in ninth for the month, remain in the middle of our ranks. Pharmaceutical stocks were the laggards in the sector, with devices, biotech, and service providers doing much better. We are overweight the device manufacturers and biotech.

The utilities sector was the worst performing group in the S&P 500 Index, and was one slot away from the worst for the quarter. This group ranks poorly in our research and we remain underweight.

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.

be sure, was that the underinvestment in inventories was progressively less severe. In the math of the GDP, that turns into a positive. But, by all measures the level of inventories continued to be cautious.

There are now signs that we have reached a level where, probably reluctantly, business is going to have to increase them. Surveys of opinions about inventories show this more relaxed attitude and it also shows up in things like truck and rail tonnage of goods shipped. While those metrics have been on the rise for a while, the data now shows that the ratio of inventory to sales is starting to require more production (and, obviously, shipment).

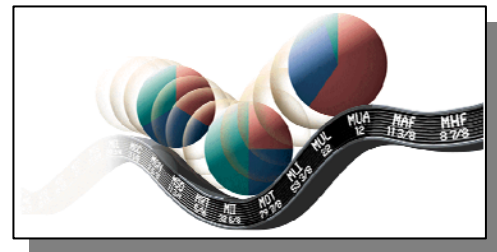
For fixed income investors, this new element in the picture has an important consequence: loans for commercial and industrial reasons are very likely to start to grow. One of the strongest relationships in economics is the tight alignment between inventories and C&I loans. So far, we have not seen this banking increase to any real degree. But the reason probably has more to do with corporate finances than with the state of the economy.

Corporations are flush with cash. They have been so cautious over the last two plus years that they could probably finance the first phase of inventory growth partly from this hoard of cash. And given the evidence from surveys of business attitudes, it would not be surprising if they did not believe in the sustainability of the pickup in demand. But it is very likely that attitudes will begin to reflect more the actuality of a global recovery and, now, expansion.

For bond investors who already face a mountain of new Treasury bonds that need to be digested, the prospect of increased credit demands from the corporate sector may cause at least a momentary disruption across the whole bond market, not just for Treasuries. While there is growing evidence of an increase in tax collections reflecting stronger economic

activity, the ultimate outcome will still be unclear for some time.

While this is happening we know that the Federal Reserve is gradually withdrawing its overt support for segments of the bond market, while probably still keeping short-term interest rates low. So while we continue to prefer corporate credits to government bonds, we are aware that an acceleration in private demands for funding can be a negative as well.



Contact Us:
Avatar Associates
575 Lexington Avenue/8th Floor
New York, New York 10022
Tel: 212-624-1900 Fax: 212-624-1934

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 \$763 million 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.