AVATAR ASSOCIATES

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The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

The continued improvement in the U.S. economy has reached several important mileposts. GDP in current dollars (i.e., including inflation) has now exceeded the highest prior level, reached in 2008. Second, rather than cutting inventories, business is now beginning an actual increase in inventories as sales have risen to a point that translates into a need to keep up with demand. These developments are very important for business managers. They signal an environment which makes a "second dip" in the economy extremely unlikely and implicitly encourages business to assume we are entering a self-reinforcing expansion. In addition to the pickup in inventory spending, managers have increased capital spending. Importantly, corporate balance sheets are very strong and the initial phase of the spending can be financed out of cash balances and cash flow, forestalling a test of the consensus thesis that credit is not available. Eventually, of course, business will have to go to the capital markets to borrow and raise funds. But before that time, broad business spending will continue to be a plus for the economy. This adds to the general strength of the economy at a time when spending in the much larger consumer sector is better than expected. Retail sales have steadily expanded even with an apparent slow growth picture in employment. In sum, our sense is that the consensus expectations for the economy will continue to improve.

Our **Practical Value model** experienced more erosion, while staying just inside the neutral zone. As the market moved higher, investor enthusiasm rose to a point which carries some risk. For example, options traders have increased their relative buying of calls and reduced their negative bets through puts. While that kind of environment can continue for a period, normally the outcome for the markets is negative. Similarly, surveys of investor opinions have reached high levels of bullishness among professionals. Except for the fact that individual investors have only recently become less cautious, these surveys suggest some risk. Corporate insiders have moved more toward the sidelines and that usually is not positive. However, with the extremely strong progression of current earnings, valuation levels are not excessive.

Our **Economic Liquidity model** is moving lower, just within the neutral zone. The Federal Reserve has ended its special program for getting the securitized markets to function again. By all measures the program was a success. Nonetheless, those markets are obviously losing some support. In addition, the Fed is now contemplating the start of a program to sell the mortgages they purchased in huge size when that market was in extreme distress during the credit collapse. Still, monetary policy probably does not yet signal an actual rise in the interest rates they control, particularly the fed funds rate. Finally, recent global concerns about sovereign risk, for example in Greece, have translated into a stronger dollar and a flight into Treasuries, lowering their interest rates, both of which are counteracting the hints of tighter monetary policy.

Our **Momentum model** has been very strong. The number of groups that have been rising has been very broad and that is always a positive. Similarly, smaller-capitalization stocks have been good performers. Trading volume has gradually expanded as well. The stocks of companies that have relatively high earnings exposure to economic growth have substantially outperformed those that are less cyclically sensitive. That is entirely appropriate given how well the economy has performed. One area of concern is that with the relatively poor performance of the large health care sector and the very modest performance of the equally sizeable technology sector, the obvious need is for a number of groups to step up to the lead. So far it is not obvious who can fill that void. Such an uncertainty in leadership often can result in a stagnant market or worse.

Our **Bond model** continues in a broadly neutral progression. This is caused by the dichotomy between the prospects for Treasuries and those for the corporate sector. While the inflation rate has so far been contained, even as the economy shows signs of expansion, the heavy schedule of auctions for new Treasuries is a challenge. Meanwhile, credit conditions continue to improve and corporate bonds have benefited. We have noted on a number of occasions how well companies are doing. Given the strong fundamentals, the outperformance by the credit sector is likely to continue. Even for Treasuries, if the economy is strong enough, tax receipts will be higher than budgeted and will reduce some of the weight which the auctions create. Based on probabilities, the edge goes to corporate bonds.

EQUITY UPDATE:

The major indices were up again for the month, though not without a great deal of volatility toward the end of the period. The S&P 500 Volatility Index (VIX) jumped to levels not seen since January and February of this year, when the markets were struggling mightily. It rose by approximately five points (from 18) in a single day recently, adding more than 25% to its value. While it is clear the domestic economy is improving, the questions revolve around its sustainability, given the uncertainty of the viability of the Eurozone, and the fact that China is in the midst of a monetary tightening that could possibly slow its economy.

For the year, "value" names have outperformed "growth" names. In fact, value under-performed during the downturn, and has out-performed since the rebound in stocks began in March of last year. Part—but not all—of this out-performance can be explained by the under- and subsequent out-performance of the financial sector. Financial stocks are up by about 80% in the last twelve months. While this phenomenon is certainly amazing, equally amazing is the fact that the telecom sector is only up 5% in the same period.

Once again, the sector performance was cyclical in nature, with the top four performers clear beneficiaries of a stronger economy. The top sector for the month was the consumer discretionary group, which has been surprisingly strong over the last year. It is in the top three for the trailing twelve months, as well as the year-to-date. The consumer, to the surprise of many and key to any economic recovery, has continued to spend. Having been stripped of homes, second mortgage ATM's, and credit lines, consumers have been buying not just food and other staples, but cars, cloths and vacations. Albeit not at the previous rate, but still…

Industrials have been quite strong as well, coming in at number two for the month. This group has been the strongest year-to-date, and second only to the financial sector over the last year. Of particular importance is the behavior of GE, which comprises almost 12% of the index. After significantly lagging the broad indices last year, GE has been very strong in 2010. We continue to overweight the group.

Energy, after poor performance over the last year, was the third-best performer for April. After crashing from $140 per barrel to $40, oil prices are back to approximately $86. Continued upward movement in prices will depend upon the condition of China's economy, as well as others around the globe. This sector has been moving up slightly in our SectorStrength model, but still ranks "neutral". As such, accounts currently hold a benchmark weight in this group.

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	Consumer Discretio	10.55%
2	Materials	3.45%
3	Financials	16.47%
4	Industrials	10.67%
5	Energy	11.18%
6	Information Techno	18.91%
7	Consumer Staples	10.91%
8	Health Care	11.55%
9	Utilities	3.58%
10	Telecommunication	2.73%
		100.00%

Data as of 4/30/10

The technology group has been a disappointment lately. At number two in our SectorStrength model, this group has been the number five performer for the year—close to the bottom of the cyclical groups. Part of the reason could be the relatively slow uptake for Windows 7 in the business world, despite very strong reviews for the product and a very lengthy period since the last meaningful operating system upgrade. It would appear that most of the cost efficiencies have been squeezed out of company infrastructures, and that companies are not yet willing to 1) hire additional personnel, and, therefore 2) buy new computers for these new hires. When, and if, we reach a level where companies are confident that the recovery is sustainable, they will, it is presumed, be willing to spend on “top line” projects. At this point, we still see a significant increase in spending for both hardware and software, which should propel the technology group upward.

The utilities sector was the fifth-best performer for April. This performance is somewhat surprising, given that the group has been, as would be expected, a laggard during the bounce-back in stocks. It ranks last in our SectorStrength model, and we remain underweight the group.

The financial sector came in sixth for the month, the worst in more than a year. This was largely due to Goldman Sachs and its recent brush with the law. We have been long-term bears for this group, but our SectorStrength model currently ranks it neutral. Hence, we are currently at a benchmark weight in accounts. Eurozone debt and who owns it has also cast a pall over the group. We have been relatively overweight the insurance sub-sector, as well as the regional bank group in an effort to avoid some of these issues.

The materials sector came in seventh. This group has been struggling, as questions linger around pricing, inventory levels, and end demand as world economies recover. On this front, China bears close inspection as we go forward. As its government continues its monetary tightening, this sector could be adversely affected. We are currently slightly overweight the group.

The next two groups, staples and telecom, are both acting as our SectorStrength model had forecasted. At eight and nine in the ranks, they have performed at nine and eight, respectively.

At number ten for the month, the one that cannot seem to find a foothold, is the healthcare sector. After strong relative performance in the downturn, this group has lost ground steadily over the last year. The primary culprit for this slippage (something we have talked about frequently) is the lack of new product development and the looming expiration of patent protection for the large pharmaceutical companies, which make up the lion’s share of the group. We have invested in the medical equipment and biotech sub-sectors, where the opportunities are greater.

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:

Among well-functioning financial markets, bonds tend to more clearly respond to economic fundamentals than do stocks. Bond prices reflect supply and demand. But they also move with inflation rates, typically falling when inflation rises. And longer-maturity bonds move in an even more pronounced fashion than shorter-dated ones.

Although the inflation rate is seen as the primary mover of bond prices, the quality of the issuer - its credit worthiness - occasionally becomes a concern. As the credit bubble burst in 2007, progressively lower-quality corporate bonds suffered severe price erosion. As the economy has found its footing, these same bonds have enjoyed huge capital appreciation.

Normally, bonds issued by countries, as compared to companies, carry much lower credit risk premium, reflecting countries' ability to raise taxes and print money to service their debt. But these are not normal times. One of the central concerns of markets around the globe is, in fact, sovereign credit worthiness. In somewhat of a replay of the credit slide into systemic risk in 2007, there is growing concern about a number of countries. In particular, a number of the members of the European Monetary Union are in a serious struggle to stabilize their economic conditions. The list includes Greece, Portugal, Spain, Italy and Ireland. It is important to note that just a few weeks ago, only Greece was of concern. The list of countries might be expanding beyond those mentioned.

The most often cited reason for the crisis is that the budget deficits of these countries is growing faster than their economies, raising the specter that tax increases and easy monetary policies will not get ahead of the slide. As a result, the prescription offered by those on the outside is to take harsh measures to reduce the size of government and thereby reduce the deficits directly. This is a standard approach taken by, for example, the International Monetary

Fund, the agency usually brought in to provide short-run assistance while the necessary austerity moves are put in place.

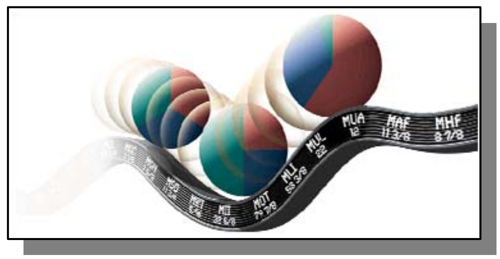
Yet, we already are seeing a potential unintended consequence of these policy actions. A few years ago Latvia got in similar trouble and has taken draconian actions to cut government spending. The result was a severe recession (for them, a depression, really) where unemployment has soared and production has been slashed. But the toll on tax revenues has been as expected in an economic contraction. Thus, both income for the country and income for the government have been cut, but the relationship of the deficit to GDP has not improved. At some point, it is reasonable to ponder, will there be a downward spiral that cannot find any equilibrium?

A more pleasant alternative to the downward spiral could be a period of strong growth which has the effect of raising both tax revenues and lowering the relationship between deficits and national income.

Beyond the Euro zone, real economic growth is, fortunately, relatively strong. In the U.S., for example, tax receipts across all levels of government are coming in higher than forecast, reducing somewhat the burden of financing large deficits incurred during the recession and its aftermath.

In the Far East, particularly China and India, growth is so strong that the unintended consequence of that route is a pickup in inflation.

For fixed income investors around the globe, the challenges are obviously complex, running the gamut from deflation to inflation. We continue to believe this is a transition year for securities and that outcomes will not be easy to forecast. With risks rising, the emphasis has to be first on capital preservation. We need to assure the return of capital before we measure the return on capital.



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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 $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.