AVATAR ASSOCIATES

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The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

One of the most important features of the investment markets of the last decade or more has been the gradual rise, across the globe, in the correlation relationships between assets of all types. That is, markets are increasingly moving together. These markets can be as diverse as an emerging country equity index and a domestic equity sector. When we first made note of this phenomenon, back in 2006, we thought that while some correlation increase was to be expected as markets around the world each became more sophisticated and intertwined with others, at a certain point the underlying fundamentals of a group or index should limit the degree of co-movement. Too much similarity among dissimilar investments leads, in fact, to instability. We saw that play out when indiscriminant buying early in 2007 led to indiscriminant selling in the crash. In both cases correlations were very high. After a period in most of 2009 when correlations fell, they began rising again this year, reaching a high-water mark this spring. One implication of falling correlations is that the markets are beginning to discriminate between competing investments. So it is very interesting, we think, that since spring the market seems to have "made up its mind" about one aspect in particular: stocks and sectors with too much economic cyclical exposure should be deemphasized in favor of less risky companies. Investors have been voting with their feet away from the economy. It is one thing for economists and analysts to give their opinion about the future, it is quite another thing for real money to move in a direction. With the economic recovery only about a year old, we think it is of particular note that there was such a downbeat assessment being made by investors. It is too early to know if those fears will be born out. In the current economic environment, small data movements in either direction can carry an outsized response by investors.

Our **Practical Value model** continues to be in a kind of no-man's land, defined as "the ambiguous region between two categories or states or conditions (usually containing some features of both)." Markets are certainly cheaper than they were a few months ago when the market was some 10% higher. The real question is whether they are cheap enough. Among the signs that worry us is a pick-up in insider selling. Those executives have a pretty good record of selling near tops and buying near bottoms. On the other hand, mutual fund flows have been heavily out of domestic equities and that, unfortunately for those selling, has been a decent indicator that stocks are, in fact, cheap. The indicators from the options markets are not providing much clarity to break the tie. Earnings multiples are also in mid-range when viewed in a long historical context.

Our **Economic Liquidity model** maintains its slightly positive tilt. Clearly the Federal Reserve is providing liquidity to the economic system by keeping short-term interest rates near zero. And while the Fed is evidencing some concern that the fledgling economic expansion is already slowing, it also seem to be waiting for even more data still that would force it into a more aggressive easing policy. But even the prospect of outright quantitative easing in the form of Fed purchases of bonds is keeping investors hanging around in Treasuries. The "unusual uncertainty" which Fed Chairman Bernanke speaks of is taking its toll on currency traders. Foreign exchange volatility is very high around the world and that raises the risk levels.

Our **Momentum model** lost ground as the equity markets moved into a volatile correction. We note some significant erosion in the underpinnings of the smaller stocks in relation to the larger capitalization companies. In addition, while huge sums have been invested in emerging market mutual funds, the performance there has been very spotty. The general theme of transition and uncertainty continues in the actions of these markets.

Our **Bond model** remains neutral. However, the position of the data suggests that the bond rally could stall out after its sharp recent improvement. In particular, some credit spreads have widened a bit. No doubt that is taking place against a backdrop of falling expectations for the economy. While that has helped treasury bonds reach extremely low interest rate levels, some concerns about credit quality would be the natural follow on. We continue to also be concerned about banking conditions in Europe.

While some countries there, particularly Germany, have benefited from weakness in the euro, it is increasingly clear that the weaker, peripheral countries in Europe are on a deteriorating economic path that will likely bring down the strong countries with them. Given the tight fabric of the global financial system, credit concerns in Europe would be quickly transmitted around the world. A "saving grace" is that European banks are much more tightly knit to the governments and bureaucrats than in the U.S., for example, and one should expect a very strong policy response to hints of trouble. This continues a path of action that has been visible since 2007 when the European Central Bank was the first of the major central banks to intervene forcefully in the credit markets.

EQUITY UPDATE:

August was another lousy month for equities, with the S&P 500 down 4.5%, the Dow Jones Industrials down almost 4%, and the NASDAQ down slightly more than 6%. The S&P Volatility Index rose approximately 25% before backing off slightly at the end of the month. Even so, this upward move did not come close to the highs of May and June, which were in the $30-40 range. The dollar rallied strongly, and fixed income yields and spreads continued to come in as investors looked for safety while reaching for yield.

In small-and medium-sized companies, "value" names performed better than "growth". In large names, however, growth names performed significantly better. This is understandable, given the fact that large companies are in relatively better shape than smaller ones and investors are therefore willing to reach for extra return in the form of earnings growth. For the year-to-date, in the large names, growth has significantly outperformed value.

The month was decidedly tilted toward non-cyclical sectors as investors looked for places to hide in the summer doldrums. The top group for August was telecom services, one of only two sectors that reported positive performance for the month. While names like AT&T and Verizon appreciated in August, the moves were much smaller than those of July, when the sector moved up approximately 9%. Even after the recent gains, AT&T and Verizon carry a dividend yield of approximately 6%, which is a lot more than high quality corporate bonds currently yield. This group has been moving up in our SectorStrength ranks, and we are currently over-weight it.

Asset Allocation Highlights

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

Sector Over/Underweights

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

Data as of 9/1/10

This commentary contains forward-looking statements about various economic trends and strategies. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. For a full set of disclosures see the back page of this commentary.

The second best performing group was the utilities sector. Many of its companies have yields between 4% and 6%. Earnings, by and large, have been stable, and interest rates remain very low. The group has also been moving up in our SectorStrength ranks, and we are currently over-weight it.

The staples group came in third for the month. Interestingly, many of its companies did not experience a decline in their earnings during the recent downturn in the economy, or if they did, it was generally small. This kind of stability is attractive in times of uncertainty, but quickly abandoned when animal spirits pick back up. The group generally ranks well in our research, but has experienced volatility within those ranks.

The healthcare sector came in fourth, rebounding from the bottom of the list. We sold our position in the device manufacturers (iShares US Dow Jones Medical Equipment Index—ticker IHI), which later under-performed the group significantly for the month. The group as a whole has significantly under-performed the market for the year. We have historically liked its mixture of cyclical and non-cyclical characteristics, but it has dropped in our SectorStrength ranks and we have trimmed holdings in it.

The materials sector, the top performing group for July, came in fifth for August. Obviously, it is heavily dependent upon economic activity, and those numbers were disappointing during the month. The bright spots continue to be in the emerging markets, where demand continues to be relatively good. If economic activity here in the U.S. rolls over, though, it will be difficult for the group to perform well.

The consumer discretionary group came in sixth, but is still at number one for the year-to-date. This sector has been surprisingly strong, though there has been some weakness in the durable and luxury goods areas. Consumers are purchasing smaller ticket items but are price conscious even there. Automobile sales have fallen by one- third since the beginning of 2008, and existing home sales have fallen to fifteen-year lows. It is quite clear that transfer payments, cash for clunkers, and first-time home-buyer tax credits have all helped, so the question remains how well the consumer holds up as these programs run out.

As a cyclical investment, the energy group has performed as a predictably higher beta play on the S&P of late. Diminished economic outlook causes both to droop, and slightly better economic data causes short-lived rallies. This group ranks poorly in our work and we are under-weight.

The technology group has been a disappointment for some time. Not only was it the eighth group for August, it is the worst performing group for the year-to-date. Cisco's recent quarterly announcement was disappointing to many, not only because the company fell short on the top line (revenues), but also due to the company's lower-than-expected forecast. A warning from Intel on Q3 earnings, and other stories of a "crowding out" effect of notebook computers by eye-popping sales figures of Apple's (lower cost) iPad have also caused consternation among investors. We are currently at a market-weight for the group.

Another highly cyclical group, industrials, came in number nine for the month. While there are a few pockets of strength within it, like agricultural equipment, the group has been struggling. It is the number two performer for the year-to-date, however, and as the economy goes, so will it.

Last for the month, was the financial sector. It has not been one of our favorites for a very long time and the dangers to it remain many. The toxic asset pool has been kicked down the field by regulators, and we have therefore only addressed a small portion of the trillions of dollars of troubled assets in existence. Our view has been that time and economic growth are two helpful variables, but you only get so much of the first, and the second seems to be going in the wrong direction. This group can ill-afford a further retreat in housing prices. With multi-decade lows in transaction volume, we are perilously close to exactly that. We are predictably underweight the group.

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:

Economists and analysts often use analogies to describe their observations and forecasts. When it comes to the overall economy the consensus has increasingly been using a couple of images associated with flying and outer space. Is the economy flirting with "stall speed?" Alternatively, has the economy reached "escape velocity?" The reason these notions are coming forward is that incoming data has forced the consensus to move to a much slower rate of growth expectation for the U.S. Broadly speaking, the growth outlook for the next year or so has receded from about 3+% real GDP increase to now probably under 2%.

In economics there is a notion that extreme rates of growth or decline are not sustainable or are not in equilibrium. But there is also a concern, although less typically analyzed, with growth numbers between 2% and 3%. A combination of population growth and productivity gains usually gives a base forecast of long run real growth of somewhere around 3%. Rates of growth slower than that will typically result in higher unemployment and underutilization of resources. The concern is that under-employment leads to low income growth which in turn leads to slower consumption and, ultimately, less production. That is, very low growth stalls out and could quickly move to the next state, recession.

Another way of seeing these movements is to hypothesize that getting above the critical long-run growth rate is analogous to reaching escape velocity in a space craft lifting off the planet.

Despite slow employment growth and a still crippled housing sector, the U.S. economy has grown about 3% in the last twelve months, yielding a very small decline in the unemployment rate. This confirms the notion of required speed. The trouble is that there are new signs that a previously very strong sector, capital and other spending by corporations, could be losing its prior vigor. For example, recent orders for durable goods have slowed fairly dramatically. Also, security analysts have started to make downward revisions to their expectations of profit growth. A good portion of these diminished expectations undoubtedly reflect a concern for credit and growth problems in Europe and evidence of a slowing in trade activity from Asia, particularly China.

The bond market has responded to these changes in several ways. First, Treasury bonds have continued to move lower in yield. Thirty-year bonds are trading at about 3 ½%, a very, very low rate. Mortgage rates are at an historic low. But recently, to reflect the increased concern in the corporate sector, bond yields on low-quality debt have started to widen relative to Treasuries.

The credit concerns have yet to move to the highest quality corporates. But if the pace of reduced overall expectations builds, then that sector will eventually feel the impact. For now, the best bet is the economy can avoid a new recession so close to the end of the last one. However, the risks are much greater now as the economy flirts with these critical growth levels.

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