



The Best Defense is a Good Offense

Summary

- A prolonged and very bad stock market, coupled with the extreme economic difficulties of the global debt crises, has many investors heading for the supposed safety of cash.
- Cash and many other cash-like instruments are not yielding enough to cover inflation, much less future spending needs, thereby costing investors anywhere from one to two percent a year in real returns.
- In contrast, many equity and fixed-income markets offer volatile but significantly higher real rates-of-return based upon some fairly prudent underlying assumptions.
- Going forward, even risk-averse investors should consider the proposition that the best defense is a good offense.

The Best Defense...

It is not difficult to feel discouraged about investing. Over the past ten years, the equity markets have been a bust. Stocks, as measured by the S&P 500, have had an annual -8% return. The world's developed economies are afflicted not only by a cyclical downturn, but by the long-term problem of too much debt. Further, at precisely the time when America's aging baby boom needs to live off of its nest-egg, the income-return from safe assets is at historical lows.

In this environment, the impulse to want to circle the wagons, hide in the bunker, or crawl under the bed is more than understandable. For some investors, this sort of defensive posture may be appropriate. But for many with a time horizon of five years and beyond, a good offense will probably prove to be the best defense.

Why does it make sense to go on the offensive and take some risk? There are several reasons:

1. Buying "safety" is expensive. Rates of return on cash and high-quality short-term fixed income are very low and in many cases yield below the rate of inflation — a real loss of principal is an almost guaranteed outcome.
2. Investor sentiment is fairly pessimistic. Individuals and institutions are either giving up on equities or hedging their bets; this is a good contrarian indicator.

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3. While the global debt problem is real, the U.S. and a number of leading developed countries have a very good history of confronting problems and making tough policy decisions when necessary. Additionally, free markets, when allowed to work, can adjust to new circumstances and produce growth even when politicians don't quite get it right.
4. China's and India's respective transitions to developed economies are occurring over a sustained period. In both countries, growth of an affluent middle-class is a big secular positive for world growth. Neither economy is over-indebted, allowing each to borrow as the developed world gets its balance sheet in order.
5. Finally, and perhaps most importantly, a number of the world's equity markets offer healthy expected real rates-of-returns based on current valuation levels.

There are three pillars to healthy, prospective growth in the equity capital markets: a favorable economic environment, an overabundance of fear and caution, and attractive valuations. The first of these pillars is clearly a point of concern, whereas the latter two offer hope as of the end of June. On balance, our assessment of these three factors makes us want to take some risk and not hide in the bunker. Let's walk through an analysis of the markets starting with the "dismal science" — the economy.

The Economic Grind

We could take either a one-to-two or a three-to-five year look at the economy, although neither assessment will have you jumping for joy. Over the short term, we know the economy is recovering at a snail's pace. Why is growth so slow? The easiest answer to this question is employment. Normally, at this stage of the cycle, the economy should be creating 200,000 to 300,000 jobs a month; instead we are struggling to produce even 100,000 new jobs. With the economy's increasing dependency on service-based employment, recoveries have become progressively slower. A new hire in the service sector doesn't translate into an extra dollar of profitability as it does in the manufacturing sector. A second issue is that businesses, particularly smaller ones, continue to suspend hiring practices due to poor sales growth and uncertainty surrounding Washington's policy changes.

Why have sales been slow to rebound? The answer to this question can be found in a more secular problem — consumers and businesses have borrowed too heavily and are now in the process of deleveraging. Over the long term, debt reduction may be a good thing. In the short term, however, the process is painful. In past recoveries, low interest rates spurred the acquisition of cars, houses, and credit-card-financed shopping sprees. Borrowers are not making that choice this time as debt levels continue to fall.

It is possible to argue that lenders, not borrowers, have changed their behavior. From this perspective, we are merely seeing the effects of overly cautious banks adhering to zealous regulation that just became even more zealous with the passage of the new financial reform bill. In fact, it is probably true that banks are not as profligate and that regulation has simply made it more difficult to lend to riskier credits.

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But it is also true that many American homeowners have negative home equity and can neither upgrade nor assume more debt for other consumer purchases. In addition, baby boomers are close to retirement and have not saved enough. This generation's savings rate is currently at 6.4% but needs to be closer to 10% for a number of years in order to produce sufficient assets for retirement. In the past, government deficit spending may have effectively and indirectly induced the economy to leverage up and spend. This was accomplished either through tax cuts, which put extra money in people's pockets, or through government spending, which injected money into the hands of government employees and contractors. It would seem, however, that these policy actions have not set off a wave of animal spirits in the economy.

The strongest argument against the effectiveness of deficit spending continues to be the rationale that spenders recognize that these injections of cash are temporary and that today's deficit spending will be offset by tomorrow's taxes. When the country had a fairly small level of government debt, companies and individuals could more easily ignore this uncomfortable fact. As outstanding government debt has spiraled closer to 100% of GDP, and the upcoming deluge of entitlement payments promises even more outstanding debt, companies and individuals cannot ignore the obvious. It can be argued that they have taken their government payments and tax breaks and held even more in cash out of concern for the future.

So, if deficit spending is relatively ineffective and interest rates can go no lower, how can we escape this mess? Are we committed to suffering the same sort of lost decade(s) of Japanese-like slow growth?

It is Always Darkest Before...

Chairman Mao finished this sentence with the words "... it's totally black." This sentiment might be what you would expect from a mass murderer who knew how to turn a phrase. Fortunately, western democracies tend to end the same sentence with "... before the dawn." Perhaps this outlook comes from the fact that established societies have a history and tradition of confronting and adapting to great economic challenges.

While I do not intend to diminish the hardships posed by debt reduction and deflation, let me introduce a few creeping rays of sunlight: When the stakes are highest, politicians and policy-makers tend to pull together to accomplish the impossible. An interesting case in point has been the extraordinary measures adopted by European governments in their effort to save the euro. Many of these nations have slashed public payrolls, tightened benefits, and laid off workers. While I am not suggesting this action has resolved the problem, these countries have made difficult decisions that would have seemed impossible a short time ago.

More Consensus on Policy Than You May Think

Interestingly, within this country, beneath the din of competing economic punditry and political fighting, there is a growing consensus as to what should happen. Present policy circumstances are, perhaps, comparable to the late 70s when inflation was raging out of control, unemployment was rising and growth was lagging. Policymakers at that time were faced with a catch-22: tightening monetary policy would have potentially controlled inflation at the expense of growth and jobs, and loose monetary policy might have saved jobs and

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fueled growth at the expense of even higher inflation. Economists, of course, warned about the perils of pursuing either policy.

Then President Jimmy Carter, a Democrat, defied expected political behavior and dismissed the prevailing loose-money arguments made by many economists in his own party by appointing Paul Volker, another Democrat, to chair the Federal Reserve. Under Volker's leadership, a tight money policy was initiated that was supported by a growing number of the world's central bankers and Carter's successor, Ronald Reagan.

Within this country, there is a growing recognition that the deficit, along with government spending, needs to be reigned under control. Conversations are less about whether this needs to be done and are instead focused on when it should happen. One side argues for immediate action while another lobbies for policy moves in the future so as to prevent a double-dip recession.

To a certain degree, these arguments are moot. Given that the U.S. and other developed countries have much of government spending on autopilot thanks to entitlements and military expenditures, meaningful cuts will take time. Rapid decreases in spending are highly unlikely, and at the same time, gradual reductions in government stimulus spending are already in progress. By allowing stimulus programs to expire, and by failing to deliver further federal support to the states (even if that support is needed to fund a federal mandate), Washington has begun to force a cut in government spending. It is quite possible political leadership over the next twelve months will look for incremental ways to reduce long-term spending the same way that European leaders across a broad political spectrum that spans Conservatives and Socialists have done recently.

Keynesian logic would say that the government should spend dramatically now to absorb unused capacity. But one of the interesting aspects of Keynes was that he was anything but doctrinaire. He was quoted saying, "When the facts change, I change my mind." Perhaps in a world where too much government debt is perceived to be a problem, it is time to do as Keynes often did and move away from orthodoxy.¹

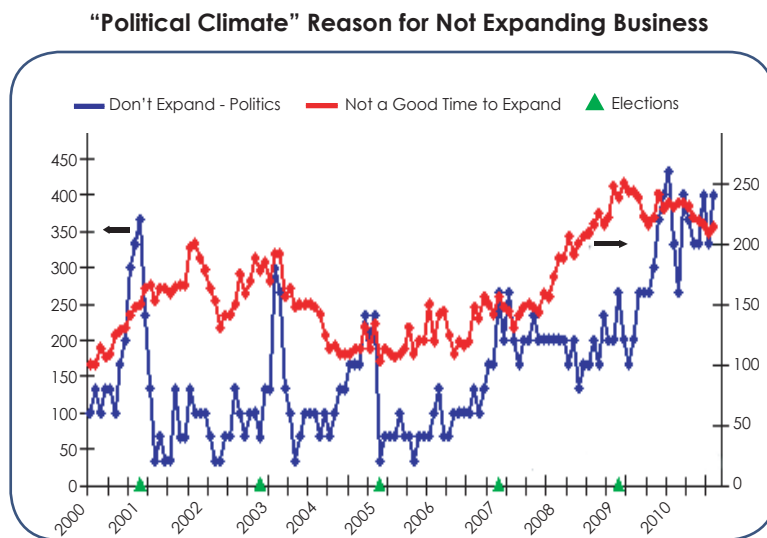
It is quite possible that businesses and individuals holding onto cash would be more willing to spend if the government implemented austerity measures to control future spending growth. For businesses and entrepreneurs, the upside of austerity is that it signals that their profits will not be expropriated through draconian taxation and monetary instability. While many individuals are not in a position to spend, many others have strong balance sheets. In addition, corporate America holds a tremendous cash reserve. A clear change in the

¹ A friend recently gave me a copy of Robert Skidelsky's short biography of Keynes, [The Return of the Master](#). Interestingly, Keynes treated economic policy as both a science and a means to a more moral society. This might come as a bit of surprise since the title of his seminal work, [Treatise on Money and the General Theory of Employment, Interest Rates and Money](#), implies a dissertation on a branch of physics versus an exposition on moral philosophy. While Keynes could be convincing, he also changed his mind when it suited him. Readers of Skidelsky's book are left thinking that while Keynes today would recommend policies intended to have a moral and just outcome, he would not necessarily make the same recommendations he made in the 1930s. "Keynesian" economics may be less of a science with a fixed set of rules and more of a series of observations on human behavior with a bias toward achieving a "just" economic outcome. I sometimes scratch my head when commentators declare they are Keynesians and recommend an economic policy based on the facts and circumstances of the 1930s. I wonder whether Lord Keynes would now recognize them as his own spawn, or whether he would have moved on to a new set of ideas.

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attitude of the government could easily trigger higher utilization of cash to spend on workers, manufacturing plants, and equipment.

The chart to the right shows how the political climate has impacted small-business owners, a group that normally provides around two-thirds of job growth. In past recessions, economic reasons were mostly cited to explain a lack of expansion whereas in this downturn, government policy weighs heavily on their decision-making. It stands to reason that a shift to a more pro-business and austere budget would actually increase business and hiring activity rather than dampen it.



Source: National Federation of Independent Business (NFIB)

The Unmentioned Secret to Successful Austerity Measures

Recession recovery 101: the sector that led the economy into the abyss will not be the one to lead us to the exit. Technology companies did not steer us out of the recession caused by the collapse of the internet-bubble, and nor will debt-laden consumers or the housing industry lead us from the rubble of the housing market. Sectors such as these remain flat on their backs for years after the end of the bubble they initiated.

This creates a problem for economists and investors trying to envision a recovery. The economy must recover without the contribution of the sector that played a hugely critical role just a few years earlier. This transition is where the magic happens. In a free and dynamic market, something else takes its place. The internet boom of the 90s rose from the energy and Savings & Loans busts of the 80s, while the housing economy that led the last upturn surpassed anyone's expectations.

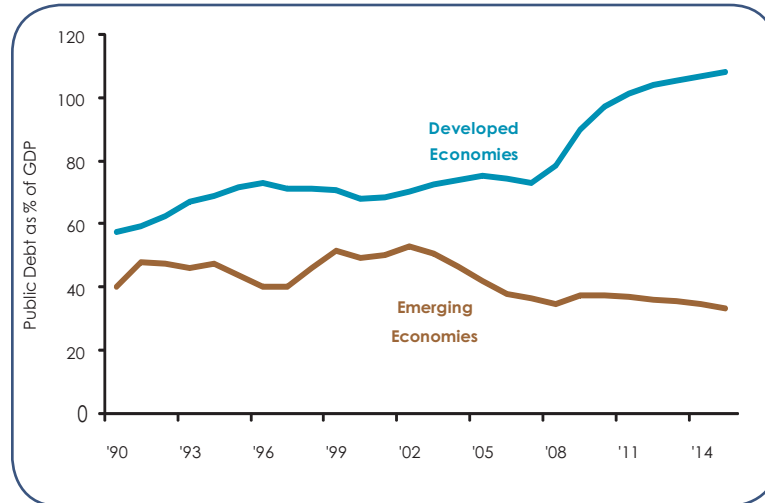
One of the reasons austerity programs work is because at some point, another phenomenon emerges that produces growth well beyond economists' forecasts, helping to revive the country enacting the austerity measures. For example, in the late 80s and early 90s, the austerity programs in Sweden, Finland and a number of other Northern European nations benefitted from strong periods of growth in other parts of the world.

Today, the "unforeseen and unexpected" source of growth will likely come from Asia. India and China have both reached a point where the growth of their domestic economies is capable of producing spillover benefits to the developed world. It is not a secret that these countries are growing. The surprise may come in the size and sustainability of the growth, perhaps leading eventually to their own bubbles. The immediate benefit of this growth can

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come either in business growth that spurs higher tax revenues or in the ability to issue debt to fund either their expansion or the issuance of debt by the developed world. The chart below shows that emerging economies are substantially less leveraged than the developed world.

Public Debt: Developed vs. Emerging Economies



Source: Strategas, IMF

Data as of 5/31/10

Valuations: Are You Paid to Take Risk?

The economic picture we have tried to draw is one of slow growth, where the global debt crisis is resolved over a prolonged period. In a sense, whether you buy or sell stocks for the long term has little to do with the economy during this year or the next, but has everything to do with whether you pay the right price. For example, the economy in 1997 and 1998 did quite well, and in fact continued to do well for the next two to three years. For this relatively short period, as stocks went from expensive to unprecedented overvaluations by the beginning of 2000, this was a good time to buy. From a longer-term perspective, this was not a great time to put money into the market. By way of contrast, the market was relatively cheap in 2002 as the internet bubble was popping and Americans were losing faith in the accounting profession. Similarly, the market reached very attractive valuation levels when some of the worst of the news was released about the banks in early 2009.

So in today's environment, are there assets with attractive valuations, and are the markets cheap or expensive? There is both an art and a science to the valuation process, precluding us from making pronouncements with absolute certainty. By our read, and based on some fairly conservative assumptions, the broad equity market may offer lower real rates-of-return than historical averages but much greater longer-term real-returns to supposedly "safer" assets such as cash, cash-like fixed income and U.S. Treasuries. Within equity markets, there are some assets that appear cheap. If we take a less conservative view about the fundamental prospects for companies, equities are broadly inexpensive.

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Cash: No Income in a Low-Inflation Environment

Let's start with the valuations on supposedly safe assets — cash instruments. The problem here is that liquid cash instruments are yielding next to nothing. Inflation is currently ranging from one to two percent per annum. Personally, I don't like paying ATM fees on my cash. Even at this low level of inflation, you are essentially paying one to two percent a year in inflation fees. Investing in a CD would maybe earn you a percent if you were willing to lock up your money for a year. At a 39.6% top marginal tax rate, you get to keep .6% after taxes. Neither alternative is a great deal relative to inflation.

What should you do? If you are risk averse, a highly liquid municipal bond portfolio with a relatively short average maturity of three to five years could be constructed to yield 1.5% to 1.75% after taxes. If you are willing to go out longer in maturity and take the risk that rates could rise dramatically, you can earn an after-tax yield of close to four percent in relatively liquid, high credit-quality instruments.

How about the equity market? Through most of the last twenty to thirty years, cash yields have easily exceeded yields on equities. The current pre-tax yield on the S&P 500 index is 2.0%. If you are willing to adopt a longer-term time horizon and can withstand some volatility, you will earn more than double the income on a CD and still have the possibility to earn a meaningful capital appreciation.

What is the possibility of seeing a meaningful capital appreciation? The art of valuation surrounds the underlying assumptions. The basic idea behind value investing is that, over time, market prices will move to fair values. This is a generally reliable bet if you have a moderate to long time horizon. What, though, is fair value? This is where the art, and more specifically the assumptions about the future, come into play.

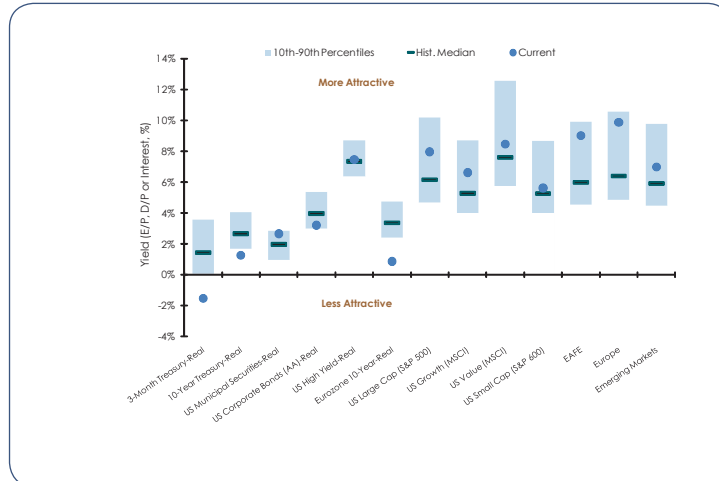
Jason Pride, our Director of Investment Strategy, has developed a model for valuing equities based upon E/P ratios. The E/P ratio is just earnings divided by price (or the inverse of the P/E ratio) and is often referred to as the earnings yield. Simply put, the higher the earnings yield, the cheaper the equity market. Here we calculate the E/P of different markets by taking the ratio of the current price to a moving average of ten-year operating earnings. The ten-year operating earnings number represents a smoothed value of what companies can earn. Jason then compares this value to the average E/P ratio for the particular market over the past fifty years, concluding that if the earnings yield is significantly higher than its historical average, it is cheap (and vice versa if it is significantly below its average). A chart of this measure for different markets is shown on the page following.² The chart also contains data on the fixed-income markets. In this analysis, Jason has calculated the real or inflation-adjusted yield to fixed-income markets.³ The basic idea is that by providing an above-average yield over inflation, fixed-income instruments represent a good value.

(2) Your head is probably hurting from all of these numbers. Given that you have foolishly become mired in the technical minutia by reading the footnotes, I feel compelled to share a few other details about this methodology for the sake of completeness. When fifty years of data is not available, as is the case with some equity markets like emerging markets, we use the longest period available. Jason also makes an adjustment to the earnings number to grow it forward five years. This has little impact on the conclusions, but produces more recognizable earnings yields. Finally, some equity markets, like Japan, have an average historical E/P that is quite low due to a valuation bubble. Rather than assume Japan will return to a valuation bubble, we have used a more normal E/P ratio as a measure of fair value.

(3) Expected inflation is estimated using TIPS and treasuries.

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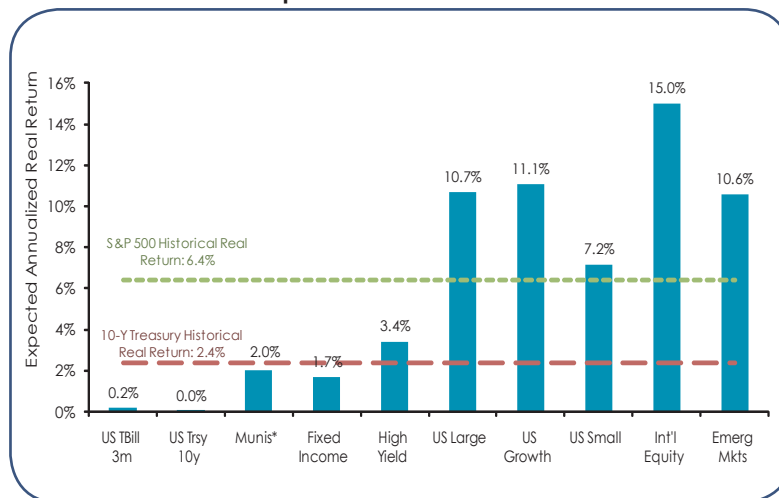
Valuation Relative to Historical Median & Percentile Bands



Sources: Glenmede Investment Research and FactSet (S&P and MSCI Indexes) Data as of 6/30/10

Based on these valuations and assuming a reversion to the historical normal valuation over the next five years, the implied expected real returns are shown in the following chart:

Long-Term Valuation Model
5-Year Expected Annual Real Returns



Sources: Glenmede Investment Research, FactSet, MSCI (Int'l Equity - EAFE Index of developed countries) Data as of 6/30/10

*US Municipal return is based on 5 year maturity adjusted to tax equivalent basis assuming 39.6% federal income tax rate

Int'l Equity return based on MSCI EAFE Index of developed countries.

Note-Information based on sources we believe to be reliable but Glenmede does not guarantee its completeness or accuracy.

Future results cannot be guaranteed.

The interesting thing about this analysis is that, by and large, equities appear either undervalued or, at the very least, fairly valued. The most attractive values are found in both U.S. and European large-capitalization growth companies. The most unattractive values include treasury bills, 10-year treasury notes and corporate bonds. Based upon this analysis, we believe that selected equities offer healthy expected returns and that investors should not overdo the amount of safety assets in their portfolios.

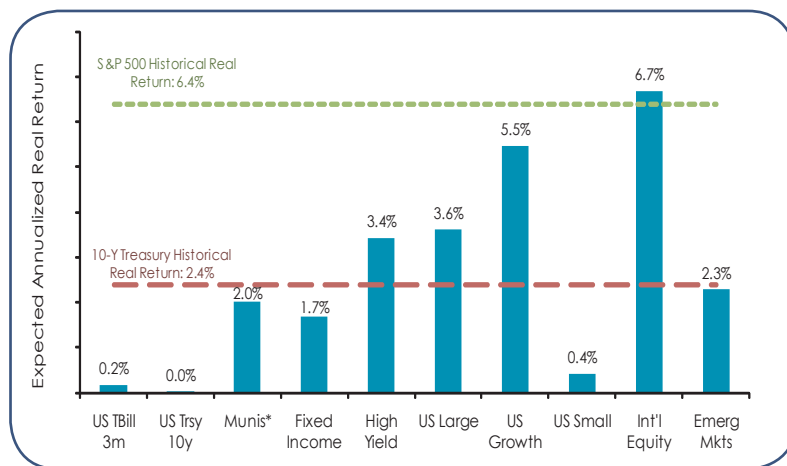
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However, let us become a bit more conservative in our underlying assumptions about fair value. In this case, we have another long-term valuation model that has many similarities to the first. With both, the model assumes prices will trend to fair values based upon a smoothed value of earnings, although a different smoothing technique is applied. In this alternative approach, we have started with reported earnings rather than operating earnings. Reported earnings include one-time write-offs and expenses, as well as ordinary operating earnings. We have also adjusted for inflation. Finally, we essentially assumed that earnings will return to profit margins closer to long-term, historical levels. Corporate profit margins have expanded dramatically over the last ten years. Profit margins represent the percentage of revenue that companies can book as profit. Using a ten-year moving average, as we did in the first model, assumes that profit margins remain at relatively high levels and that corporate America has, on aggregate, made a fundamental paradigm change. This is not a completely outlandish assumption. For example, retailers facing merciless competition will typically have a lower profit margin than drug manufacturers that tend to have a monopoly on certain pharmaceuticals. It is possible that U.S. companies have transitioned from low-margin businesses into higher-margin operations, changing the historical relationship.

It is also possible that high margins will be competed away, that reported earnings are a more valid measure of earnings results, and that inflation distorts past data. Hence, we have calculated another valuation measure that accounts for all of these factors. Based on this more comprehensive approach, we calculated from the measure the following five-year real rates-of-returns for each major asset class.

There are some key differences in the results. Notably, the expected annualized real rate-of-return of ordinary U.S. equities is lower — approximately 3.6% at the end of June — in comparison to the greater than 6% for the S&P 500 historical long-term average.

Margin and Inflation-Adjusted Valuation Model 5-Year Annual Real Returns



Sources: Glenmede Investment Research, FactSet, MSCI

Data as of 6/30/10

*US Municipal return is based on 5-year maturity adjusted to tax equivalent basis assuming 39.6% federal income tax rate.

Int'l Equity return based on MSCI EAFE Index of developed countries.

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So which measure represents true value? Before answering this question, let's first focus on the commonalities. In the tables adjacent, we rank the 5-year annualized expected real returns to each of the models.

First and foremost, we see that equities produce a much higher real rate-of-return than safety assets (cash, treasuries and short-

term municipals) even with more conservative valuation assumptions. Second, similar assets show up at the top of the list: U.S. growth stocks and international equities. High-yield bonds with 'BB' ratings also show up as one of the most attractive fixed-income assets capable of producing an attractive real rate-of-return in both models.

These commonalities end up having a substantial impact on our current recommendations. To a certain degree, we don't need to know which model is more accurate. We will hold more in international, U.S. growth and high-yield fixed income than our normal position. We will steer our recommended portfolios into lower weightings in low-risk assets. The pie charts below show our recommended moderate-risk asset mixes for high-net-worth investors, and endowments and foundations with \$5 million or more in account assets. This recommended allocation is structured to carry an equivalent amount of risk to a traditional 60% stock / 40% bond portfolio, which may not be appropriate for all investors. As always, it is important to review your financial circumstances and risk tolerance with your portfolio manager in order to determine appropriate long-term allocations to your portfolio.

Long-Term Valuation Model

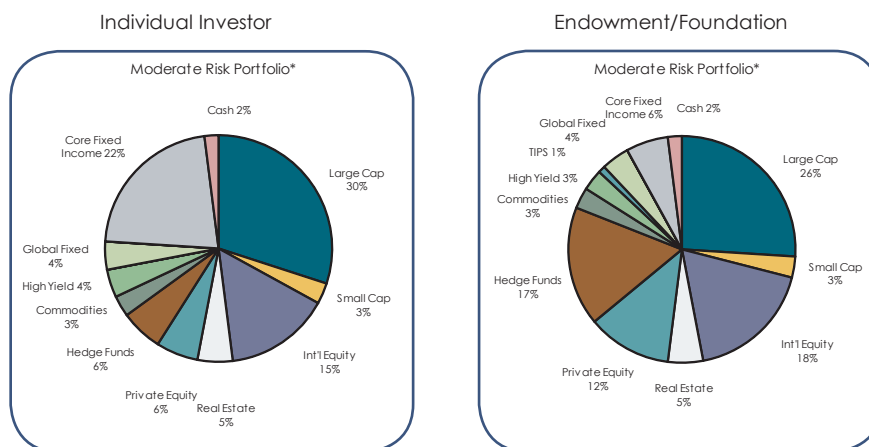
Asset Class	5-Y Annual Real Return
1. US TBill 3m	0.0%
2. US Trsy 10y	0.2%
3. Fixed Inc	1.7%
4. Municipals*	2.0%
5. High Yield	3.4%
6. US Small	7.2%
7. Emerg Mkts	10.6%
8. US Large	10.7%
9. US Growth	11.1%
10. Int'l Equity	15.0%

Margin & Inflation-Adjusted Model

Asset Class	5-Y Annual Real Return
1. US Trsy 10y	0.0%
2. US TBill 3m	0.2%
3. US Small	0.4%
4. Fixed Inc	1.7%
5. Municipals*	2.0%
6. Emerg Mkts	2.3%
7. High Yield	3.4%
8. US Large	3.6%
9. US Growth	5.5%
10. Int'l Equity	6.7%

Data as of 6/30/10

Asset Allocation Recommendations*



* The ability to implement this recommendation depends upon investable assets. The appropriateness of this recommendation to any one portfolio depends upon tax and liquidity objectives as well as other considerations.

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'Truer' Version of Value

But let's stop dodging the question about which model offers a "truer" version of value. One model does imply substantial gains for the equity markets while the other indicates that equity portfolios will produce a significant premium over low-risk assets with relatively low nominal returns.

Let's first acknowledge that fair value is an imaginary number partly rooted in both history and reality. If overwhelmed by the thought that the economy is threatened by deflation and slow-to-no growth, investors will value equity assets closer to our more conservative assumptions. If they believe we are returning to normal times, investors will push equity prices toward our more optimistic measure of value.

Our guess is that this choice is going to remain unresolved until the world's developed economies appear to have gained a firm grasp of the debt crises. Until then, prices will vacillate between both levels. It will be important to buy when the market becomes obsessed by deflation and slow growth, and trim positions when the market becomes too happy and starts pricing in a quick return to normalcy. It should be strongly noted, however, that both models conclude that long-term investors should invest in equities and other risk assets if they want to generate a real rate-of-return on their investments.

The best defense during these uncertain times, in our view, is a good offense.

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