GLENMEDE

Review & Outlook

By Gordon B. Fowler, Jr.
Chief Investment Officer, Glenmede

Investing in a Staircase Market

Summary

- Over the last century, the stock market has experienced two distinct, long-term trends over five separate periods. Market prices have moved steadily upward, or traded sideways into volatility.

- There are some investment strategies that work well in both market cycles, and some which work in one and not the other.

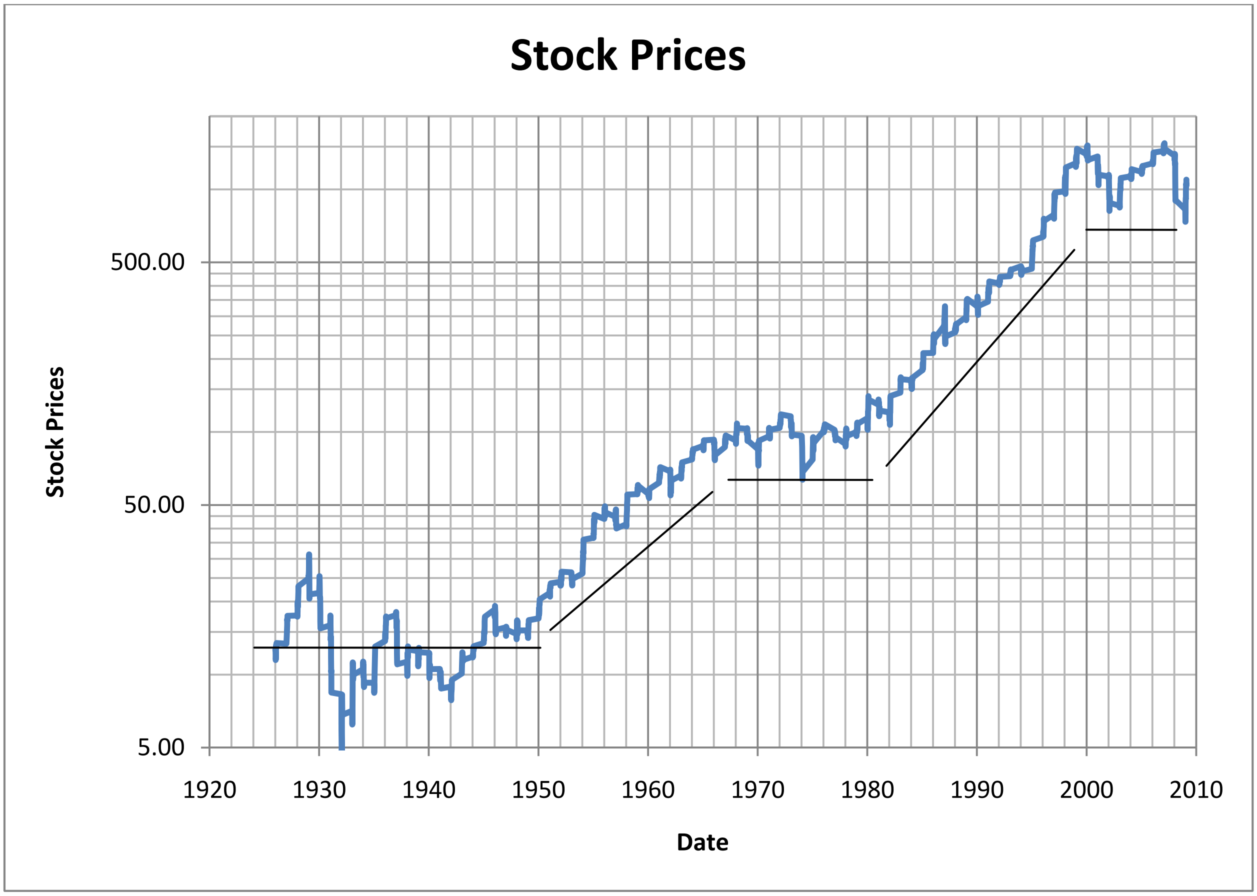
  For example:

  - Strategies that tilt portfolios toward the most undervalued assets, and capture long-term secular themes work in both upward and sideways markets.
  - Buy and hold equity allocations work well in periods of steady growth (*i.e.* upward markets), whereas volatile, sideways markets typically require more trading and a reserve of stable assets for opportunistic purchases.

- It is difficult to know with certainty which of the two markets will ultimately prevail. Our assumption is we are in the upswing of a volatile, sideways market that will require us to employ a combination of investment strategies.

- As we have argued in prior reports, it is likely worth taking some risk but in a diversified and controlled manner: overweight relatively cheap assets; maintain exposure to important long-term economic themes; invest a portion of the portfolio in absolute-value managers and strategies; and keep a portion of your portfolio in stable assets.

- Finally, some additional thoughts on my role in the New Year.



<u>Stock Price Growth in Staircase-like Movement</u>

What do you see when you look at the above chart? Beside the faint resemblance to the outline of a staircase, we see the markets travel through some very long-term cycles, either moving steadily upwards or, trading sideways into volatility. From my seat, I see five distinct time periods with alternating trends.

In three of the periods, roughly 1928 to 1948, 1967 to 1980, and 1999 to present, I see markets that peaked and traded in a volatile, sideways fashion. During these sideway markets, stock prices seesawed back and forth as investor sentiment vacillated between bullish and bearish extremes. In contrast, during two of the time periods, roughly 1948 to 1967 and 1980 to 1999, stock prices trended steadily upward.

To me, these patterns are related. Likely, underlying these five separate periods, there is an economic rationale for why we alternate back and forth. The periods of relatively strong returns were characterized by stretches of above-average global growth with either low or declining inflation. Risk premiums generally shrank as markets became progressively convinced the good times would last in perpetuity. Shrinking risk premiums in the form of higher P/E ratios and falling bond yields generally translated into higher asset prices. Unfortunately, periods of growth often foreshadow periods of extended volatile, sideways markets.

The growth periods leading up to volatile, sideways markets were first driven by beneficial changes in technology and trade. This might be characterized as 'good' growth which improved productivity and the wealth of nations. These 'good growth' periods, however, generally end badly as businesses and policy-makers pursue actions to sustain the growth but which also unintentionally induce financial excesses. Both the Great Depression and the collapse of the tech and housing bubbles were characterized by an overextension of credit into projects and assets without sufficient return. The Great Inflation of the late 60's and 70's was, in essence, created principally by misguided monetary policies which attempted to sustain the Post World War II boom in the United States.

At the end of a growth period, stock valuations have generally been stretched to reflect an overly optimistic picture of the future rather than the reality of some fairly shaky and unsustainable economic circumstances. During the subsequent volatile, sideways periods, the markets essentially worked off their excessive valuations. Earnings more than caught up to prices by the end of the 'sideways' periods, leaving attractive valuation levels and setting the stage for a sustained bull-market run.

For a moment, let's assume stock markets continue to experience the two very long, separable cycles I described. How should we invest? As suggested earlier, there are investment strategies which work in both upwards and sideways markets, while certain strategies are appropriate in only one set of market circumstances.

Successful Strategies for Either Market

Buying relatively inexpensive assets is a strategy that generally works in any market cycle. In practice, if you have the choice between two assets and one sells for a cheaper valuation, you are generally better off buying the cheaper and selling the more expensive. For instance, we underweighted small-cap stocks and increased our international exposure in April of 2004 because small-cap stocks looked relatively expensive and international stocks provided a much better value opportunity. Over this time, small-cap stocks measured by the Russell 2000 earned a cumulative return of 9.1% (1.6% annualized) while international stocks measured by the MSCI EAFE earned a 37.5% cumulative return (5.8% annualized). Small-cap stocks haven't underperformed every year and international stocks haven't outperformed every year during this time, but buying at inexpensive valuations has a way of working out over long periods. In a way, it's no different than any other form of shopping. Whether you shop at Neiman Marcus or Wal-Mart, the objective is to buy high-quality goods at reasonable prices.

Currently, the most undervalued parts of the world's asset markets include: U.S. Quality and Growth Stocks, European Equities, and High-Yield (Junk) debt. Our recommended portfolios are heavily skewed towards these assets as shown in the recommended portfolio for moderate risk investors.

Traditional Asset Mix Growth With Income Objective		Diversified Asset Mix Growth With Income Objective	
Risk Assets		**Risk Assets**	
Large Cap Equity	60%	US Large Cap (Quality/Growth)	23%
		Small Cap Equity	2%
		International Equity	12%
		Special Strategies	15%
		Private Equity	6%
		Commodities	4%
		High Yield Bonds	6%
		Global Fixed Income	3%
Total	60%	Total	71%
Stable Assets		**Stable Assets**	
Fixed Income	35%	High Quality Corp Credit	0%
Cash	5%	Core Fixed Income	26%
		Cash	3%
Total	40%	Total	29%
Stock Market Beta	0.63	Stock Market Beta	0.64

The other investment strategy which tends to work in both upward and sideways markets is to identify long-term economic themes that will play out over many years. During the 1970's, energy investments proved a durable story. In the 1990's, the internet boom led to sustained gains in technology investing. In the most recent decade, non-U.S. investments, as well as hard assets, have become a theme as growth outside the United States has accelerated.

This strategy can be both easy and dangerous. The easy part is the themes are not too difficult to spot. The hard part is the assets benefitting from these cycles can become dangerously overvalued. You do not want to be the last person investing in an asset driven by a particular theme. In the current environment, while international investments remain relatively undervalued, hard assets are trading above long-term, inflation-adjusted, historical averages. We suspect this theme will continue as hard assets go from being somewhat overvalued to very overvalued.

Investing for Growth Markets: "Cash is Trash"

The key difference between investing in sideways cycles versus growth markets is the role of cash or stable value assets. In sustained growth markets, 'cash is trash.' Lower yielding, stable assets provide nothing more than frictional costs and generally earn return rates below the rate of inflation. Even a simple technique like rebalancing and taking profits can yield opportunity costs and investor regret. Towards the end of these cycles, investment gurus write books about the importance of investing for the long-term and almost characterize the stock market as a perpetual motion machine constantly moving upward.

Investing for Volatile, Sideways Markets: "Buy and Hold: Dead and Cold"

Stable assets cushion the overall volatility of the portfolio and become a reserve to opportunistically buy assets periodically reduced when investors alternately rush for the exit and entrance in spasms of pessimism and optimism. This sort of 'trading' can either be done in a very systematic or active fashion.

The most systematic, and in a sense, easiest way to make money during volatile, sideways markets, is to regularly rebalance your portfolio to neutral weightings in equities and bonds, selling after the market goes up and buying after it goes down. This process can potentially add one to two percent in additional return in an environment where you fight for every extra gain. A more active policy is to either make absolute valuation decisions, or allocate to a manager who makes absolute valuation decisions.

Absolute-value investors compare the value of available assets with what they could earn relative to 'riskless' assets like cash or short-term bonds, and probably fare better in a volatile, sideways market. These investors know the market may decline so they search for substantial discounts and if they correctly estimate fair value, the asset substantially appreciates. If the market weakens, they view themselves as in a safer position since their asset(s) have already suffered a severe price decline. If they can't find an asset selling at a substantial discount to fair value, they hold money in cash.

In contrast, relative-value investors take a slightly different perspective and merely tilt their portfolio towards the cheaper of several equity or equity-like assets. If equity markets fall however, both assets may decline in price and hopefully the cheaper asset depreciates less. Over time, if the market appreciates or even trades sideways, relative value decisions can still succeed. In a sideways market, however, they will probably not perform as well as absolute-value strategies.

How easy is it to make absolute valuation decisions? In broad markets, such as trading between stock indices versus cash, it is very difficult. It becomes much easier when considering two equity or equity-like assets. Generally, to make an absolute valuation decision, an investor looks for substantial asset misevaluations. Broad markets like the S&P 500 rarely reach valuation extremes and the opportunity cost associated with being out of the market can be significant.

It is much easier to make absolute valuation decisions by specializing in a particular area and investing in very specific securities. The greatest valuation opportunities often lie in highly complex assets which only a limited number of specialists can adequately value. The Special Strategy and Private Equity line items in the second column of the above recommended portfolio include a number of managers with this capability. As example, Royce is a special-situation investment manager in our open architecture platform who makes absolute-value decisions on specific stocks and holds cash when he cannot identify substantially discounted companies. Royce has a strong long-term record and has done a good job protecting capital in down markets. He and his team also go through long periods when they underperform the broad markets and do worse than the S&P 500.

Many hedge fund, private equity and distressed debt managers also fit into the absolute-return camp. Derivative strategies like selling covered call-options are another strategy worth considering in a sideways market, particularly if options prices are mispriced.

<u>So which market? Growth or Volatile, Sideways</u>

We really can't, just by looking at a graph, say for sure which type of market will emerge over the next five years. In part, the future is hard to forecast because human intervention alters the trajectory of trends. For instance, The Bretton Woods Gold Standard and General Agreement on Tariffs and Trade (GATT) allowed the economies devastated by World War II to recover rapidly. Jimmy Carter's appointment of Paul Volcker as Federal Reserve Chairman, and Margaret Thatcher and Ronald Reagan's election, changed the sideways trend of the early 80's. The invention of the semiconductor and the proliferation of internet-based technology altered the shape of growth in the 1990's.

Based on the facts, it is possible to envision both trends. Certainly, with extremely high-debt levels, budget deficits exceeding ten percent of GDP in the U.S. and many developed countries, and significant global trade imbalances, you can argue the world's economies face considerable risks. On the other hand, our banking system is less precariously positioned, Asia is experiencing a long and substantial period of economic growth, and near-term earnings growth looks quite good.

If we have to choose a scenario, we suspect we are in the upswing of a volatile, sideways market that will last awhile longer. We see a recovery likely to produce better-than-expected economic and earnings results. However, the deleveraging process, at some point, needs to occur. It's hard to imagine how this process will not constrain long-term global growth.

With this forecast, investors will need to continue taking risk to capture an economic upswing, but will need to be ready to step aside to avoid a deleveraging-induced downturn when absolute-equity valuations reach an extreme.

This means we should prepare portfolios, as best as possible, for both types of markets. This will require us to rely heavily on techniques that tend to work in both markets such as tilting towards relatively cheap assets and assets benefiting from the Asia growth story. It also means maintaining a moderate risk exposure in order to capture the gains of an upswing, but utilizing disciplines that perform in down markets such as regular rebalancing, the use of absolute-value strategies and, if appropriate, the strategic use of certain option-based strategies. With this approach, we are less dependent on the accuracy of a forecast. If we further refine the recommended moderate risk portfolio based on the concepts discussed, we advise the following:

1. **Overweight Relatively Cheap Assets:** Quality Growth Equities, High-Yield Bonds, and European Equities.

2. **Maintain exposure to some important long-term economic themes:** Non-dollar stocks and bonds, commodities and other hard assets.

3. **Invest a portion of the portfolio in Absolute Value Managers and Strategies:** Selected value oriented stock pickers and hedge funds. Consider a covered call index strategy.

4. **Keep a portion of your portfolio in stable assets:** as a means to dampen volatility and as a reserve for opportunistic purchases.

The Morning Routine after 1/1/10

On January 1, 2010 a few things will change for me. One practice that will not is my morning commuting pattern. In the past, the Glenmede President has driven into the city. I have commuted into and around cities by train my entire career and, at this point in time, I am not looking to make a switch. I could suggest, with a trumped-up level of piety, this dedication to mass transit comes from an earnest concern for the environment. While partly true, it's also true I don't like spending the ungodly sum required to fill my gas tank. I can also say with a fair degree of conviction, I prefer to get my morning news by leafing through a newspaper than from the radio.

Yet, the real reason I will stick with the train may be Dave, the proprietor of Guppy's, the coffee stand at the Bryn Mawr station. Without Dave and Guppy's, the station is cold and charmless. The walls are cinder block and the floor cement. The color of the walls is that cheerless institutional green seemingly required in all state-run facilities.

Dave not only provides a useful service, but he works hard to make the station a community. His storefront is more than a food dispenser, but furnishes the walls with pictures and the outdoor planters with spring and summer flowers. There are now a few old tables and chairs to offset the prison-like benches lining the walls. The coffee shop features a colorful, hand-painted sign with the Guppy's logo, also printed on the t-shirts and hoodies available for purchase. Part of the charm of being Dave's 'client' is that he not only learns your name, he introduces you to his other customers.

At first his operation bothered me a bit. Rather than quickly pumping out my morning supply of decaf coffee, Dave makes me wait while he uses his espresso machine to brew me a fresh cup. He purposely, I believe, overrides my standing request for skim milk and instead slowly stirs in a dollop of whole milk. All of this idiosyncratic ritual robs me of precious minutes that could be spent tapping my foot on the platform floor.

My commute is not the only thing that will remain unchanged in 2010. One of the things I have most enjoyed since becoming CIO of Glenmede has been writing investment reports for you. From a very practical perspective, writing forces me to take a jumble of investment ideas and organize them more clearly and succinctly.

Editors and clients alike have suggested I have a tendency to ramble and in the process, waste readers' precious time with useless verbiage and impertinent information. My writing style is also a little too casual for some. I accept the criticism (and as a result, we intend to format more information in a compact and clear style). But these idiosyncrasies are not without their purpose.

The world of economics and investing can be, for non-practitioners, about as cold and charmless as the inside of the Bryn Mawr train station. Most writing is aimed at industry insiders and has the same vibrancy as the station's institutional green cinder-block walls and cement floors. This is a shame since most of the country's critical subjects revolve around economics in some manner. Something like an unfunded government pension fund and its benefit formulas may be dull, but will likely impact your children and grandchildren more than 90% of headline news on any given day.

So part of the reason for discussing pools, children and greyhounds, and writing in a conversational style, is an attempt to take a page of out of Dave's book. My hope is you will want to actually walk inside this space and spend a bit more of your precious time with us. It is also very consistent with Glenmede's overall approach to our clients. We realize you may not actually live to hear the latest in investment thinking, financial planning or trust law, but we want to ensure we are as approachable and proactive as possible.

I wish you a very happy holiday season, and a good and healthy new year. Just as I have little intention to shift my commuting habits, I will continue writing to you, although perhaps at a slightly slower pace. In contrast, over the next few days my preparations for the holidays need to quicken; there are a lot of gifts still to be purchased. I do plan, however, to make one purchase for myself, and that is to get one of Dave's t-shirts.
