

Recent Volatility: Questions and Answers

The market upswing that began in March 2009 is seeing its first real test of sustainability. Why?

First, financial markets continue to battle against growing concerns of a European sovereign-debt crisis. Further unsettling things, German Chancellor Angela Merkel recently called for an end to naked-short selling. This practice was already banned in the United States and, on the surface, should not be a significant development. Unfortunately, markets assume that when politicians call for change, it's because they know of impending doom. That Merkel acted alone further raises suspicions that Europe is unable to deal with the sovereign-debt crisis in a unified manner.

Second, the Senate passed a financial reform bill that exceeded the expectations of Wall Street analysts. In particular, the bill will limit how banks underwrite derivatives as well as the scope and extent of their proprietary trading operations. Both businesses have been important revenue generators for the financial services industry. It's worth acknowledging that financial profits make up a disproportionately large percentage of stock market earnings. In addition, the markets fear that these moves will unintentionally impact liquidity, limiting access to cheap financing by non-financial companies and households.

Has recent volatility changed Glenmede's view on how to allocate between assets?

Glenmede continues to recommend a neutral weighting to risk assets. In accounts holding only stocks, bonds and cash, this approach means we were neither over nor underweighted equities. In accounts with a more complex allocation that include alternative assets and high yield and global bonds, we managed risk exposure so that we were neither over nor underweighted equity-like risk assets.

Going into this year, U.S. stocks were not cheap by our longer-term valuation measures. However, we believe investors can be quite myopic and will tend to focus on economic and earnings news over the next twelve to eighteen months. We still believe the global economy is in recovery mode and will continue to advance. The earnings picture, particularly in the U.S., remains positive for 2010 and also into next year. This trend should allow stock prices to move upward.

What would Glenmede do: buy, hold or sell?

In short, the answer is 'hold.' For now, we would hold off adding to equity positions until two conditions are met. An ideal buying opportunity comes when there is both good value and

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good news that allows us to see a light at the end of the tunnel in regard to the current set of problems. Our secular market view envisions a protracted period of sideways, volatile equity markets where it will be important to step up at times, buy on dips, and trim positions after market rises.

From our perspective, a good buying valuation point comes at around 1015 on the S&P 500 (as of the May 20 close it was 1071). At this point the market is fairly valued based upon our long-term valuation model for U.S. stocks.

In addition, we would like to hear news that indicates we have reached a turning point in the sovereign-debt crisis. To be realistic, this crisis will take years to resolve, but the markets need to see progress as soon as possible. The trend in LIBOR, the rate at which banks loan each other money, will be a good indicator of a turning point on these issues. As fears increase, LIBOR has steadily gone up a basis point or two each day. We would like to see this rate stabilize and maybe even decline a bit. This will likely occur once there is greater coordination by European governments and the implementation of meaningful policies. LIBOR's stabilization or decline would be a good signal of improved confidence.

With these two conditions met, we would urge clients to increase equity positions to normal long-term weightings. If markets decline further, we would be inclined to step up and move to an overweighting in equities.

[You have recommended international equities and specifically, European equities. Have you changed this view?](#)

To be precise, we have liked European equities but not the currency. Most of our managers and strategies have hedged a portion of their euro exposure by buying European equities back into dollars. This has provided protection from the full brunt of the euro's decline.

Not surprisingly, we look for the same criteria when buying international stocks as when selecting U.S. stocks: good values and good news. In our view, we have reached the point where international stocks represent a good value. The EAFE index is trading at about 13 times next year's estimated normalized (mid-cycle) earnings. In comparison, the U.S. is trading at more than 15 times normalized earnings.

One positive piece of news is that Europe's economy is driven by exports. As the euro declines, their exports become more competitive and the potential for earnings growth improves.

[Does Europe deserve a lower P/E ratio?](#)

Temporarily, yes. Over the long term, European earnings per share have grown at about the same rate as U.S. earnings per share; European and U.S. stocks should have about the same P/E ratio. Value investing works because investors embrace long-term valuation decisions based on rationale in lieu of short-term considerations. Predicting how the market will move is difficult. Buying when an asset is cheap does not require a crystal ball.

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What is the probability of a severe market correction?

We believe the probability of a severe correction is less than 20%, and that what is happening remains in line with our 2010 expectations of a more sideways, volatile market. Ten percent market swings and changes in sentiment are not out of the question when news oscillates as it has recently due to the uncertainty caused by the debt problem. But we think we are closer to the nadir than the peak of this recent news cycle as European governments scramble to develop a credible plan. It is possible that the European political system could still fumble, leading to a much larger decline.

What is the probability of a double-dip recession?

If we define a double-dip recession as one that recurs within two years following an initial recovery, we believe any reoccurrence will be isolated to specific regions. For instance, the U.S. appears to still be gaining momentum, pushing towards 2010 economic growth in the 3% range. As well, emerging-market and commodity-oriented economies, such as Australia, are concerned about growing too fast. In these instances, a double-dip recession seems unlikely. In contrast, 2010 expected European growth is only 1% and with the austerity measures being implemented in many of those nations, a double-dip recession is far more feasible in this part of the world.

Does it make sense to buy some form of protection like a put on the S&P 500?

Right now protection is fairly expensive. The cost of a one-year S&P 500 put that pays after the 10% decline would cost about 9% of the amount insured. In other words, the market would need to decline by about 20% to just cover the cost of this insurance.

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