

INSIGHTS

Quarter 4, 2010

Uncertainty Between Extremes

"THE MORE PRECISELY THE POSITION IS DETERMINED, THE LESS PRECISELY THE MOMENTUM IS KNOWN, AND CONVERSELY." – THE UNCERTAINTY PRINCIPLE OF QUANTUM PHYSICS

The Uncertainty Principle asserts that it is impossible to simultaneously determine both the position and direction of an electron, or any other sub-atomic or quantum particle, with any degree of accuracy. Today's investor may feel this principle is as applicable to economics and finance. As financial markets have oscillated between extremes, so too has investor sentiment. From surprise over the strength of the global economic recovery, to concern over a double-dip recession, investors have come full circle and now expect the recovery to continue.

At the start of 2010, some investors were wowed by the rapid economic rebound in the U.S. and many emerging nations. Optimists argued that corporations had too aggressively reduced their workforces and would need to rapidly replenish these ranks. These same corporations, the optimists said, would put to use the cash piling up on their balance sheets and increase capital expenditures. Additionally, the growth in emerging markets would further propel the global economic recovery. In hindsight, economic growth was extrapolated too far into the future, setting the stage for disappointment.

Proponents of the pessimistic viewpoint note that most global economic indicators (Chart 1) have been pointing to an economic slowdown for some time. In past economic recoveries, robust job growth had provided consumers with ample income to drive the economy forward. However, employment (Chart 2), which had improved through most of 2009, has remained relatively unchanged this year. Small businesses, which account for nearly two-thirds of new U.S. job creation, remain hesitant to expand. Without this segment's contribution, economic growth has been weaker than normal. Even more worrisome, both consumers and governments carry burdensome debt levels.

Investors have been whipsawed between these divergent viewpoints, leaving them uncertain of their position or direction. In isolation, the arguments underlying each have relatively sound reasoning. Yet, what if neither viewpoint is ultimately correct?

The optimistic perspective could prove accurate but may take longer to develop than initially forecasted. Corporations, with more than 12.5% of their balance sheet assets in cash (Chart 3), do have room to increase hiring and capital spending once the outlook turns more positive. Similarly, emerging economies' healthier fiscal standing (Chart 4) and propensity for economic growth means they will likely support and help finance global economic growth for years to come. However, neither alone can carry the economy in 2010.

As for the pessimistic viewpoint, what if excess debt need not be reduced immediately? What if, instead, developed governments and over-leveraged consumers gradually reduce spending and repay excess debt over many years? Low interest rates, the result of a stimulative monetary policy and growing investor desire for fixed income, may provide the opportunity for many developed countries to slowly resolve their debt issues. The resulting long-term economic growth would still be weighed down by gradual debt reduction, but a downward economic spiral would be less likely. While it is difficult to see the U.S. government suddenly enacting the necessary corrective policies, European nations recently implemented rather significant austerity programs despite widespread unpopularity.

Amidst this uncertainty, we believe it is important for investors to consider both arguments as each has merits. The global economy and markets may follow neither path exclusively, instead finding a course somewhere in the middle. We believe the middle will be a fine line in which the economy gradually

reduces its debt and slowly increases employment, eventually transitioning from recovery to modest expansion. However, the transition will likely be bumpy and is contingent on world leaders making informed decisions in a timely manner. Modest growth, should things unfold as expected, still leaves the overall economy more vulnerable to external shocks. As a result, we foresee continued above-average volatility and subdued returns for most asset classes.

It appears the markets are feeling the effects of investor uncertainty. Since 2008, more than \$600 billion has poured into bond funds while \$250 billion has been withdrawn from equity funds (Chart 5). This has occurred at a time when the yield gap between bonds and stocks is the lowest in over 50 years (Chart 6) — suggesting investors expect little growth from equities. While we may not believe economic growth will suddenly accelerate, it is difficult to conclude that growth will drop to and remain at zero for a prolonged period. As a result, we believe investors are justified in taking some risk, in part because fear has created value opportunities. We continue to recommend reduced allocations to core fixed income assets, favoring a diversified basket of risk assets such as European multinational equities, high-yield (BB) corporate debt and U.S. quality growth stocks. We also recommend an allocation to emerging market equities that offers direct exposure to secular growth while diversifying away from the indebted developed nations.

Lastly, we recommend an allocation to volatility capture strategies, such as covered calls and market-neutral hedge funds, that are structured to either capture and benefit from above-average volatility or outperform in more volatile environments.

Today's environment of confusion and uncertainty provides opportunity. Investors willing to reason through the arguments will realize the ultimate outcome is likely to be more muted than either extreme. By moving beyond the national debate and paralysis, investors can benefit from valuation discounts and secular themes likely to outperform over a longer period.

GLENMEDE'S MARKET ANALYSIS TEAM



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Economic & Market Outlook

Key Economic and Market Viewpoints

- **The global economic recovery is slowing.** Employment gains have stalled, small businesses are worried, and economic stimulus is fading.
- **Developed nations face a significant headwind due to outsized deficits and debt burdens.** Consumers face a similarly large future deleveraging.
- **The global economy is likely to avoid a double-dip recession,** but it remains susceptible to future disruption.
- **There is a growing political will to reduce government spending.** Consumers are already doing their part with increased savings.
- **Fears of deflation or a double-dip recession have driven the cost of protection to unsustainable levels.**
- **Investors are justified to take some risk** due to meager yields on lower-risk investments (money markets and Treasuries) and reasonable equity valuations.

Investment Strategy Recommendations

- **Allocate to a diversified basket of risk assets,** while underweighting low-yielding alternatives such as cash and Treasuries.
- **Shift portfolio allocations toward undervalued/attractive assets.** We currently see opportunities in the following areas:
 1. **European equities:** discounts due to sovereign debt concerns.
 2. **High-yield debt:** the best option in fixed income.
 3. **U.S. quality growth:** cash flow supports dividend growth.
 4. **Growth in emerging Asia:** direct and indirect exposure.
 5. **Volatility capture:** invest to benefit from above-average market volatility.

Market Analysis in Brief

Chart 1 Global Economic Recovery Is Moderating

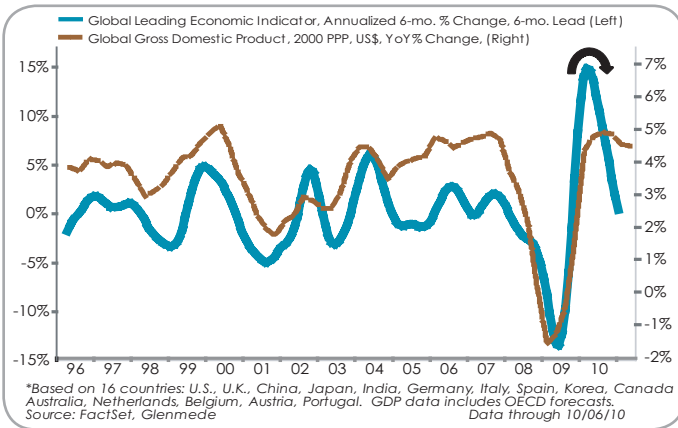


Chart 2 Unemployment Claims Stuck Between 450,000 and 480,000

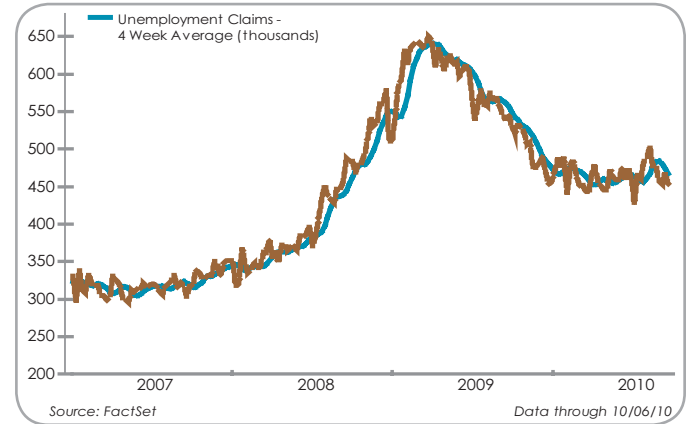


Chart 3 S&P 500 Companies — Cash as Percentage of Total Assets

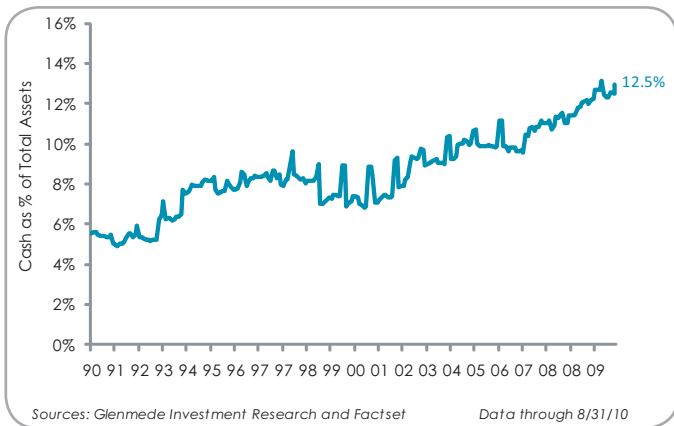


Chart 4 Fiscal Picture Looks Better in Emerging Economies

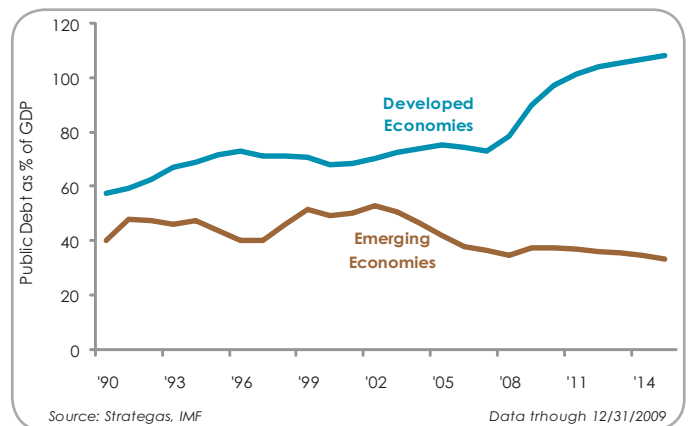


Chart 5 Investors Favor Bonds over Stocks

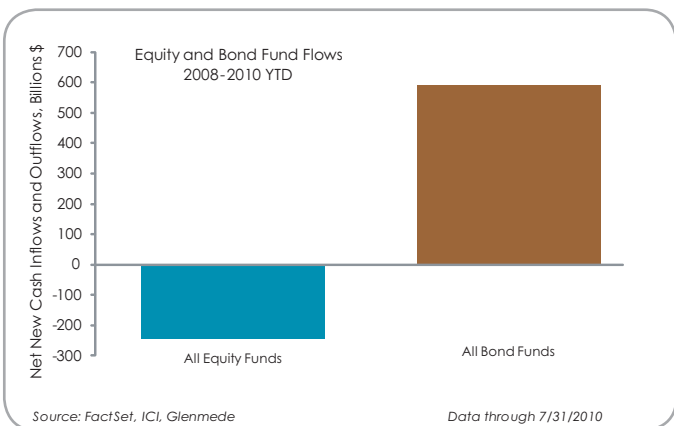
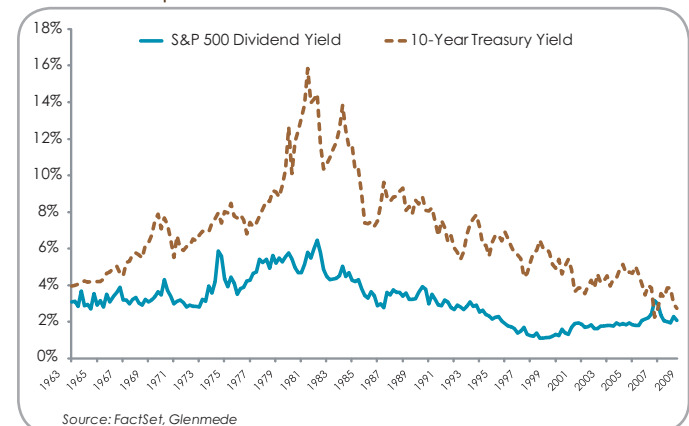


Chart 6 Yield Gap between Stock and Bonds Implies No Growth



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