



Uptrends and Unfinished Business

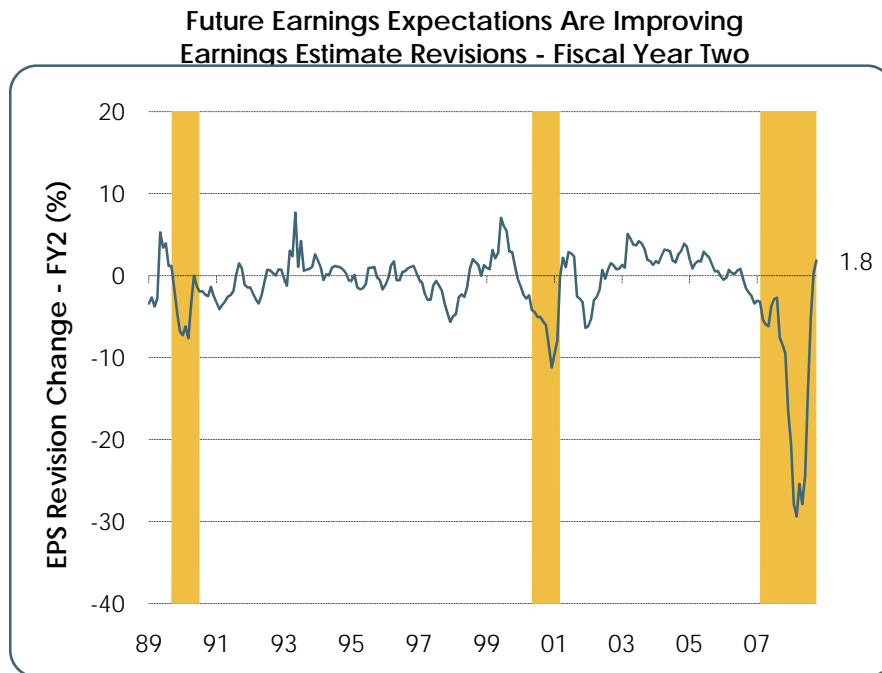
- As we noted last month, improving economic data is causing an uptrend in earnings. Given that equity markets tend to follow earnings upwards, and that earnings are well below normalized levels, we could be looking at a sustained upturn.
- While the economy may no longer be on the brink of an abyss, unfortunately there is still some unfinished business. The American consumer and the financial sector have just begun the deleveraging process. Meanwhile, the government continues to rapidly increase the amount of leverage it shoulders. This does not seem like a situation which can be easily reconciled without some economic pain.
- If history is a guide, the market can delay worrying about economic excesses for a long time, and will focus instead on positive near-term earnings trends. This means investors are faced with both the tradeoff between investing defensively against future long-term market turbulence, and incurring the opportunity costs associated with a near-term upswing in the market.
- With short-term cash rates next to zero, some risk taking is necessary to grow the real value of a portfolio. Risk taking needs, though, to be done selectively. We conclude by outlining several recommendations for investing in this difficult environment.

Muted Joy

I should applaud a rising stock market. Clients are happier. The world just seems a little better. In fact, there are elements of the recent rally that justify a degree of happiness. World economies are no longer “on the brink of an abyss” and economic growth seems within reach. I do, however, have the feeling the economy and the markets still face some serious ‘unfinished business.’ This unfinished business, deleveraging by both consumers and the government, has the potential to derail the pleasant uptrend we are now enjoying.

Earnings Trends and Market Cycles

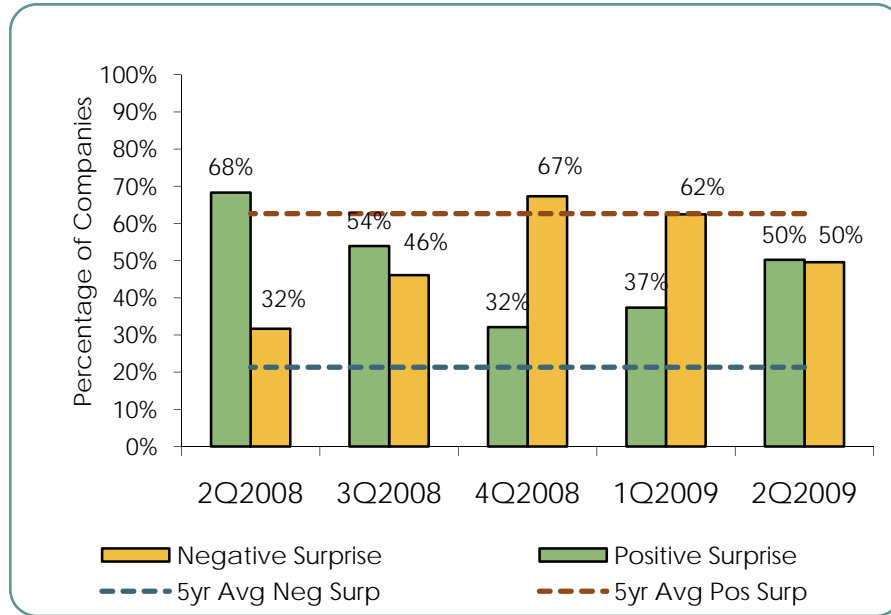
As noted in last month's *Review and Outlook*, "Six Signs of Happiness," the economic data is getting progressively better. Global economies seem to have improved thanks to the natural healing power of the free enterprise system and massive amounts of government stimulus. The most important indicator of economic health, from the stock market's perspective, is the fact earnings are being revised upward and are no longer declining.



*Sources: Glenmede Investment Research, FactSet (Russell 1000 Universe
Average 3-Month Change of Fiscal Year 2 Estimates)*

Some commentators argue that the positive earnings revisions come from cost controls and expense cuts. Expense cuts, so the thinking goes, are potentially a one-and-done phenomenon and do not serve as the basis for sustainable earnings growth. It is true that companies have exercised enormous discipline and controlled costs during this time period. It is also true that earnings surprises usually come as a result of cost cuttings. But even this is too glum a view. Research by Val de Vassal, our Director of Quantitative Research, shows that company revenues are coming in above analyst expectations - indicating that earnings surprises are not just a product of corporate cost-cutting measures.

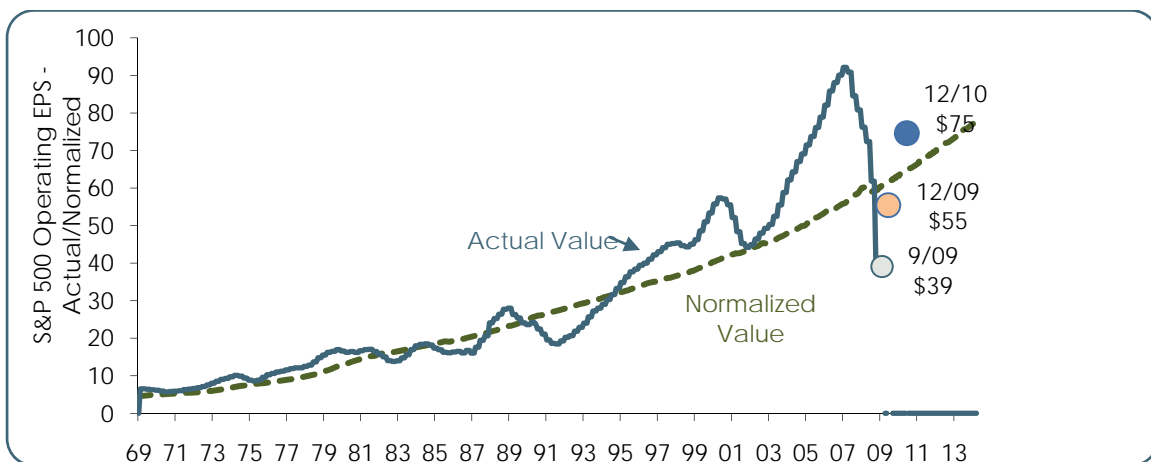
Half of S&P 500 Have Positive Revenue Surprises S&P 500 - 2nd Quarter 2009 Revenue Surprises



Sources: Glenmede Investment Research and FactSet (Reported Revenues through Sept. 1, 2009)

Earnings trends are, to the stock market, the equivalent of holding a carrot before a horse's nose. The horse will focus just a few feet ahead and follow the carrot in whatever direction it is pointed. Similarly, the stock market will look out twelve months in time and follow the direction of earnings projections.

Historically, Earnings Have Been Cyclical S&P 500 Index - Actual/Estimates Versus Normalized Values



Sources: Glenmede Investment Research, Haver Analytics and FactSet (First Call projected bottom-up EPS estimates)

As we have suggested before, the story of the market can be explained with a review of a twelve-month earnings history. The stock market began the decade with earnings at a peak. As earnings expectations dropped with the collapse of the Internet bubble, the stock market fell. As earnings began to rebuild from the low levels of 2002 and 2003, the stock market began a multi-year expansion. This growth did not waver until July of 2007 when earnings began to roll over. As earnings collapsed to levels well below the trend lines of 2008 and 2009, the market also fell apart. The latest round of data indicates earnings are on the upswing; a rise in the stock market seems to be in the cards. Since earnings are so depressed, it is quite possible this growth will last for some time.

Economic Crises and the Slow Road to Recognition

If we go back in time, we arrive at another lesson about economic excesses and market cycles. The excesses that eventually result towards the end of a bull market seem to be identified well in advance of their actual occurrence. Alan Greenspan made his famous statement about the irrational exuberance in the stock market on December 5, 1996, well before the collapse of the Internet bubble. The stock market appreciated by another 109% and Greenspan subsequently softened his view on the bubbling markets before the market peaked in March 2001 and bottomed in October 2002.

The housing bubble wasn't really a surprise, either. Commentators began talking about it as early as 2003 and 2004. The quote below is taken from the July 15, 2005, issue of *The Economist*:

"NEVER before have real house prices risen so fast, for so long, in so many countries. Property markets have been frothing from America, Britain and Australia to France, Spain and China. Rising property prices helped to prop up the world economy after the stockmarket bubble burst in 2000. What if the housing boom now turns to bust?"

The S&P 500 would rise another 29% before it peaked in October of 2007 and, then bottoming at 667 in March of 2009. The question, inevitably, becomes: "How should investors weigh the difficult choice between potentially incurring sustained opportunity costs associated with forgoing medium term trends, with investing in the face of a seemingly terrible but distant event?" We will consider the answer to this question a little later. First, let us ask whether we are heading into another period of economic excess and stretched valuations. The answer is, of course, yes. We are always heading either into a period of excess or out of it. In this case the excess is probably the continued expansion of debt from the American economy.

Deleveraging: Unfinished Business

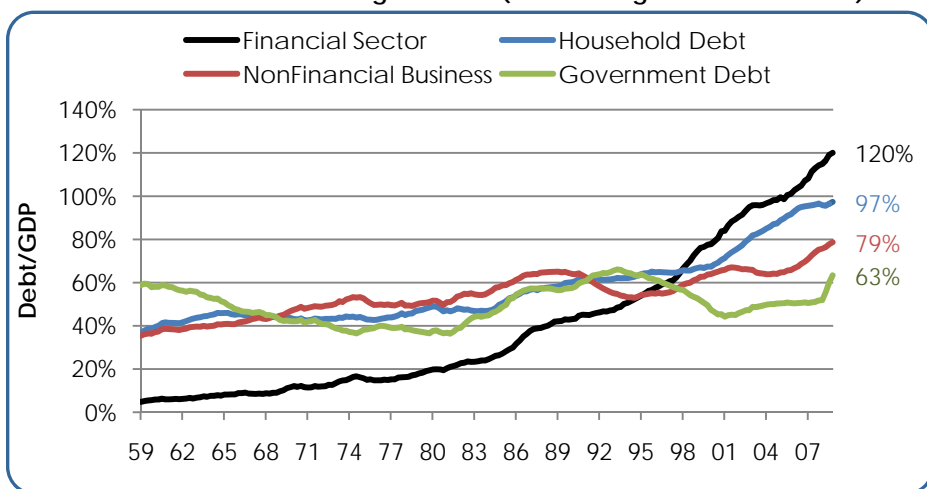
It is not entirely appropriate to say that too much consumer debt caused the market collapse. Individuals and entities can accumulate increasing levels of debt without causing a collapse. Instead, problems occur when borrowers can't repay the debt. In the recent downturn, high debt levels accrued just as things became particularly painful.

Over the past decade, consumers and financial institutions piled on more and more mortgage debt. Consumers based their optimism on the belief they would remain employed, the price of their home would rise or stay flat, and that they could refinance (if they really understood) their adjustable-rate mortgage. Financial institutions bought mortgage debt on the premise they understood the risks associated with an increase in defaults.

When oil prices spiked and pushed the world into one of its regular downturns, these optimisms and premises fell apart. Consumers began to default on their mortgages at unprecedented rates. Banks discovered they did not fully understand the credit risks of their mortgage debt and were faced with insolvency as asset values collapsed. In turn, the stock market collapsed as lending practices froze. The market did not turn around until housing and mortgage assets were written down to sufficiently low levels such that a) consumers could step in again and buy houses and b) banks and their creditors could foresee an end to write-downs.

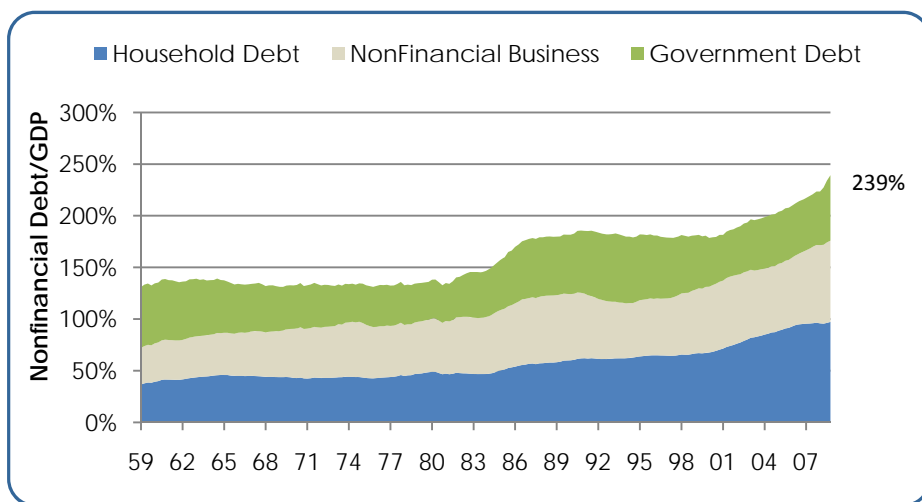
So, where are we now? The credit bubble of consumer and financial institution debt is deflating slowly. Another credit bubble of government credit is inflating at a very rapid rate. The sum total of both trends is an unprecedented and unpleasant increase in total debt to GDP.

Surging Government Debt Is Offsetting The Slowing Of Household Debt Debt As Percentage Of GDP (1959 Through 1st Quarter 2009)



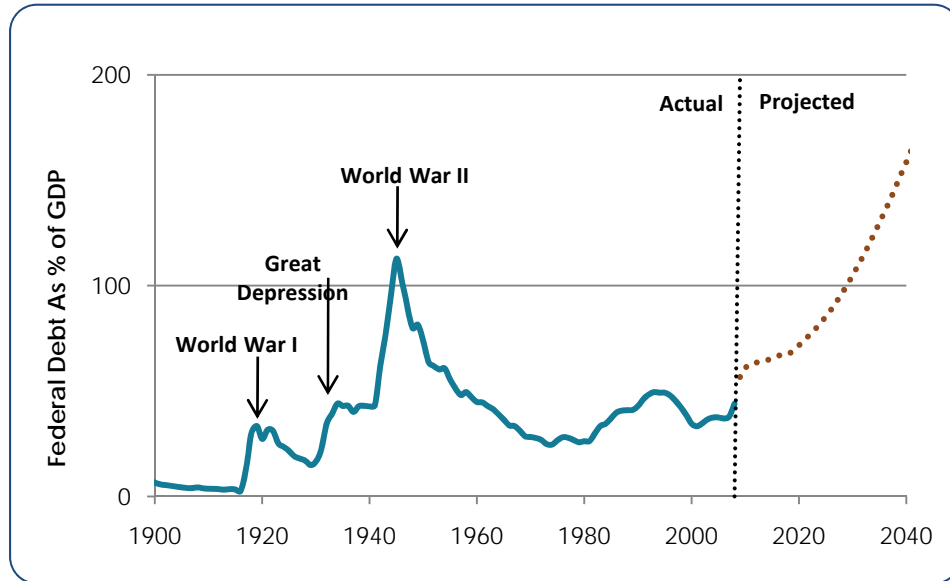
Sources: Glenmede Investment Research and Haver Analytics (FRB: Credit Market Instruments)

Total Nonfinancial Debt As Percentage Of GDP (1959 Through 1st Quarter 2009)



Sources: Glenmede Investment Research and Haver Analytics (FRB: Credit Market Instruments)

Federal Debt is Projected To Rise to Unprecedented Levels



Sources: Glenmede Investment Research and CBO (Projected based on average of baseline and alternative fiscal scenario forecasts)

Could this latest credit balloon fix itself if the economy recovered? It doesn't seem likely unless taxes are raised by a massive amount. While consumer credit might slow, a recovering economy may incent consumers to slow down the deleveraging process. Some economists have argued the gains seen in the savings rate might even reverse as asset values have increased and Americans have potentially felt wealthier.

Government debt is a whole other problem. As the economy recovers, tax revenues will help close the deficit. However, we will face a systemic problem. Regardless of whether we pass more stimulus measures or expand access to healthcare, the trend over the next ten to twenty years is ugly. Two forces are at work. First, the baby boom's retirement places great stress on entitlement programs as retirees become a larger percentage of the population. Second, healthcare costs are rising at rates in excess of inflation. The reason for the second problem is fairly simple. The existing "rationing" system for both private and public healthcare programs basically isn't functioning very well. Governments ration by limiting access to services. Private companies ration by pricing services beyond the means of some customers.

Americans want neither government nor insurance companies to refuse their healthcare claims. Insurance companies that deny healthcare claims are accused of putting profits before people (even in regions of the country where not-for-profit companies control close to 80% of the market). Alternatively, rationing by the government creates visions of "Government Death Panels" for some and the very real prospect the government will have to limit services to control costs.

Both government and insurance companies argue that if we modify the system, we will realize better outcomes for less money. Perhaps this is the case. At the end of the day, however, healthcare seems to be a service people in this country will demand without restraint if it isn't limited by either private market prices or government fiat. Unless consumer behavior changes dramatically, healthcare budgets will probably rise in excess of the inflation rate for a sustained period until some rationing is built into the system

How soon will we have a problem?

So, will an increase in debt bring the market and economy down imminently? This is by no means certain. We could be on an upward-ride that lasts anywhere from five months to five years. As long as the earnings "carrot" is still moving forward, the market will probably be led upward.

Alternatively, we could experience a hiccup in growth if the lending system shuts down as it did in the Fall of last year. Notably, this time around the borrowers who have a hard time accessing credit could include the U.S. government.

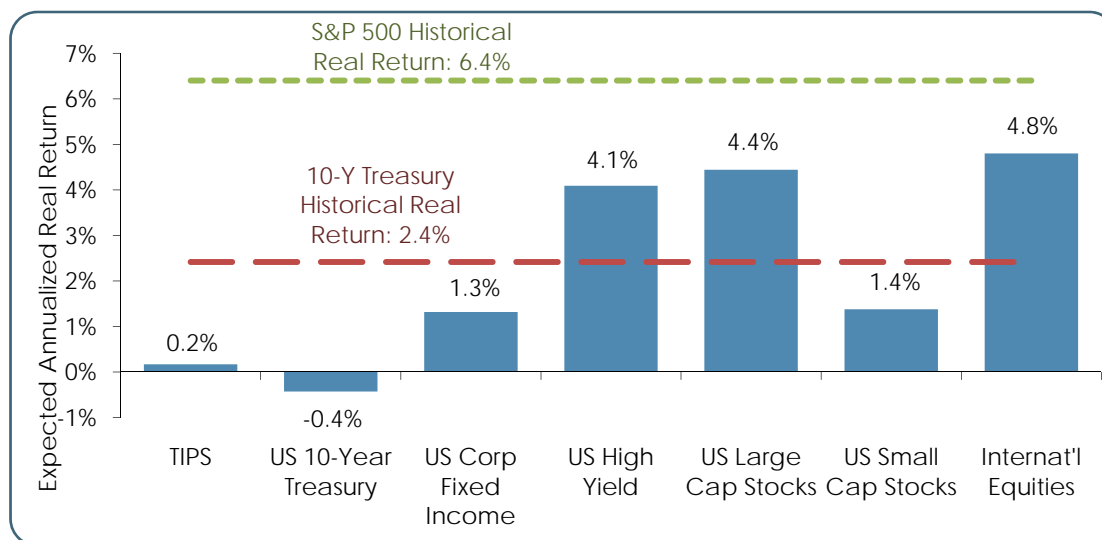
This is far from a comforting thought. If history is a guide, it will be a long time before investors recognize the "elephant in the room." Still, it's hard to enjoy the first few days of a cruise if you know your ship will likely hit an iceberg. Is it worth investing in the face of this risk? That depends, in part, on whether you are paid to take the risk.

The Valuation Gauge: Are you being paid enough to take risk?

Life is full of uncertainties and risks. If you are paid to take risk, it has historically been worth it. Stock and bond valuations are a means of gauging whether you are rewarded for assuming risk. So, do valuations also reflect whether investors are rewarded? Yes and no. The chart, below, shows our expected five-year real returns for different asset classes. These numbers are derived from current valuation levels. Generally, the numbers are all positive and somewhat below historical rates of returns for stocks and bonds.

They are not, however, all that high compared to historical real return levels. There is a basic disconnect. In a world where way too much debt is issued in U.S. dollars, shouldn't the rates of return on debt and equity capital be well above average? Does a yield to maturity on 10-year Treasury Debt of 3.4% or a dividend yield of only 2.1% on the S&P 500 make any sense? At some point bond or stock investors will want to be paid a lot more (i.e. yields go up and prices go down). Alternatively, a combination of taxation and/or more consumer savings reduces bottom line corporate earnings (resulting in the need for prices to go down to offset lower earnings and lower after tax yields).

Projected 5-Year Asset Class Real Returns



*Note- Information is based on sources that we believe to be reliable but Glenmede does not guarantee its completeness or accuracy
Future results cannot be guaranteed.*

Once again, there needs to be a catalyst like the spike in oil prices that tripped the credit crises last year to force downward price movement. It would appear, though, that the global economy is turning around for the better rather than the worse, leaving room for more positive than negative catalysts.

Definition of a Cautious Risk Taker

This analysis seems to argue that investors should be cautious risk takers. What is a cautious risk taker? It is someone who actively searches for stocks, strategies and assets that generate equity-like returns without taking equity-like risks. The hunt for investments with these characteristics may take us into particular sectors of the equity market, the debt market, international currencies, offbeat managers, private equity and even, gasp, certain types of derivative strategies. One of the managers we use, Marty Whitman of Third Avenue, characterizes his version of this approach as buying assets that are "cheap but safe."

Another way to summarize this attitude comes from an uncle of mine. After having spent his youth being thrown out of some of the finest schools in America, he moved to Europe to race on the GT circuit. Much to his disappointment, I did not share his interest in cars, much less ones traveling at high speeds. This did not discourage him from taking me on the German Autobahn so I too could sample the joys of high velocity travel. In the midst of some rapid shifts in acceleration, for both the car and my stomach, he noted that a good driver, even while trying to gain the lead, simultaneously thinks about safety. At every instant the driver tries to answer the question, "where will my car be in the event something goes badly ahead, and can I put myself in a position where I'll be somewhat protected?"

Enough stalling. What do I do with my portfolio?

Equity market valuations are okay and the trend (in economic growth and earnings) is our friend. In this environment we recommend owning some equities. However, we suggest taking selective risk which means looking for places with attractive valuations. We will start with the basics and work our way towards more complex recommendations.

- 1) **Invest in growth equities – particularly “quality” growth companies:** “Quality” has a lot of definitions. For some, quality constitutes companies with sustainable business models, high historical returns on capital and a high level of free cash flow. For others, quality is a measure of the pristine nature of corporate balance sheets. The former definition has done better, since the bottom of the market, than the latter. We would not split hairs here. Instead, we would take a broad approach to quality and tilt portfolios in this direction.
- 2) **Overweight corporate credits at the expense of equities.** We have recommended this theme since the beginning of the year. For the year-to-date period, credit has been a fairly good investment particularly on a risk-adjusted basis. High-grade and high-yield corporate indices have returned 13% and 41%, respectively versus a return of 15% for the more volatile S&P 500. While corporate yields have continued to decline, we plan to stay with this trade for a bit longer. We would, however, avoid investing in some of the lowest-grade high-yield debt.
- 3) **Allocate to International Equity:** Some of the more attractive valuations are overseas, particularly in Europe. The European portion of the EAFE international stock index has a dividend yield of 3.6% compared to a yield of 2.1% for the S&P 500. It is easy to point out that Europe has historically had lower growth than the U.S. and hence, deserves to have companies with lower valuations (i.e. cheaper multiples). It is also worth noting that Europe has already made the transition to a higher tax/slower growth economy where the government takes a much larger percentage of the economy. The U.S., in contrast, may only just be beginning this journey.

The real risk to overseas investing is that the rest of the world’s economies are excessively dependent on exporting to the American consumer or countries (i.e. China and India) that export to America. Here we note that if you invest in either Asia or Europe, you take a similar risk but you are paying a far higher price in the case of the former’s equity markets. Based on this thought, we tend to hold back from emerging markets and tilt more towards the rest of the world.

- 4) **Invest in “special strategies”:** There are strategies and managers that invest in a fairly idiosyncratic way which are less correlated to the equity markets. These managers may under- or over- perform the indices by wide margins over intermediate time periods but tend to generate good absolute returns over the long-term. These managers generally think of earnings in terms of an absolute rate of return and will stay on the sidelines if they don't find anything attractive to buy. This is, in essence, a bottoms-up means of making sure your portfolio is not overexposed to an overvalued market. This definition can include both traditional “long-only” managers and hedge funds. Our Manager Alliance Program identifies such managers and is prepared to offer recommendations for your portfolio.
- 5) **Allocate to international fixed income and commodities:** One possible outcome over the next few years is that the dollar will lose its status as the world's reserve currency. In this environment, owning non-dollar securities or owning assets that will be priced based upon global standards seems appealing. International Fixed Income, as managed by select managers, strikes us as an interesting strategy. We also like global fixed because it strikes us as a great place to add value through active management. There are dozens of investible fixed income and currency markets and these markets, thanks to central bank policies, are often not priced efficiently.

Earlier this year we urged investors to add to commodities, including gold, and then to quickly cut back when prices jumped. Since that time, commodities have, for the most part, treaded water while the equity market has risen. We would have starter positions in hard assets and gold miners.

- 6) **Invest in strategies that sell volatility in the options market:** In a flat-to-moderately rising market, a covered-call strategy can add value. The options market is, in essence, an insurance market for equities. The market goes through phases when insurance is both cheap and expensive. Right now insurance is expensive. Investors that pursue strategies where options are sold can benefit from the high cost of insurance. Options strategies are very complicated and may require a reasonable amount of assets. If you are interested to explore this area more, we suggest talking to your Portfolio Manager.
- 7) **Consider private equity, particularly secondaries:** One of the interesting facets of the last market cycle is how many investors got caught in illiquid positions. Private Equity and Hedge Fund investing were quite popular prior to the market collapse. Both investments, though, can suffer from illiquidity and that has turned out to be a substantial problem for some investors who made very large commitments to these assets. As a result, a number of large investors have offered to sell their positions at cents on the dollar. Similar to options, private equity is not for everyone. Your portfolio needs to be of a certain size before it makes sense.