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Operation Alpha

October 2010

As you are aware, we continue to believe that the volatility that has characterized financial markets over the past several months are likely to persist. Volatile markets, such as 2010, are often driven by a lack of consistent compelling investment opportunities. In order to continue to navigate choppy markets, we believe a three step approach to investing is prudent. First, we believe investors should consider the expanded investment opportunity landscape offered with the use of both defensive and opportunistic alternative strategies. Second, we plan to focus on those investments that we believe have the greatest probability of maximizing total return for a given market environment. Third, a more nimble, tactical approach is necessary to help manage market risks while taking advantage of potential opportunities.

As we continue to seek the optimal blend of risk and reward for portfolios, alternative strategies may play an increasing role in providing access to the broader investment opportunity set. Alternative strategies give investors the ability to fine tune their desired risk exposure. A variety of strategies are available with varying degrees of sensitivity to the stock market. Since we expect volatile markets to persist, more defensively oriented strategies may be used at a market peak while more opportunistic strategies can be employed at market bottoms.

Volatile markets can often call for focusing on a smaller group of investments that we believe possess the greatest probability of providing excess returns, or “alpha”, in the prevailing market environment. While maintaining a diversified portfolio is always prudent, increasing one’s allocation or weightings to a relatively smaller group of investments may present a more compelling opportunity given the current market conditions. The focal group of investments will change depending on whether financial markets are at the top or bottom of a volatile trading range.

For example, at the top of a trading range, volatility-thriving alternative strategies, or those that seek to mute the impact of volatility, might be the portfolio focus. Using alternative strategies that have a lower sensitivity to stock price movements may assist portfolio performance. In the equity market, a volatile and potentially downward trending market calls for an emphasis on dividend paying stocks as a way to buffer against volatility and help capture the best total return prospects of large company stocks.

Focusing on maximizing risk adjusted returns in an upward moving market does not mean focusing solely on stocks. For example, commodities asset classes and raw materials specifically, are the main ingredients that fuel the increasing production that accompanies economic expansion. Commodity and alternative asset exposure can therefore be used alongside stocks and bonds as a tool to increase opportunities in investment portfolios.

In the bond market, upwardly moving markets call for a focus on more economically sensitive sectors such as high-yield bonds and emerging market debt. As the economy continues to expand, even slowly, prices of high-yield bonds and emerging market debt may benefit and the extra yield helps buffer against volatile markets.

Focusing on different groups of investments when the market is at a near-term top or bottom highlights the need for investors to continue using a more tactical approach to investing to help take advantage of volatile market conditions. The investments ideas employed as a rally matures will likely be different than those used after a pullback. Taking profits after a market rally and seeking opportunity when markets are oversold is a great way to produce alpha.

The rules that focus on a more select group of investments and use more alternative strategies may result in a portfolio with a slightly different look than these to which investors have become accustomed. Portfolio allocations must be more dynamic and adapt to market opportunities and challenges as they arise. For example, when market conditions are favorable and volatility is to the upside, a traditional 60% stocks, 40% bonds allocation might shift to 65% stocks, 5% alternate strategies, and 30% bonds. Not only would the portfolio allocation shift towards assets that may benefit more from an upwardly moving market (stocks or commodities), but the shift also would entail more cyclical, or economically sensitive, investments. Conversely, when few opportunities are present the allocation might shift to 50% stocks, 10% alternate strategies, and 40% bonds. In this case, we would seek to reduce exposure to investments that may be adversely affected by downside volatility and employ volatility-thriving alternative strategies.

These allocations are hypothetical examples and are not representative of any specific situation, but illustrate how we can continue to alter the traditional set-it-and-forget-it stock and bond portfolio of the past as we prepare for the future. As always, please contact me if you have any questions.

Sincerely,



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