

Investment Update: The Summer of our Discontent II

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One year ago this week, I wrote about the economic malaise that had thrown the normally quiet summer vacation season into turmoil. With yesterday's global stock market rout, we once again find the world on edge as the drumbeat of global recession pounds from nearly every media outlet. At times like these, investors clamor for news and find it hard to know what they should be thinking or doing when it comes to their portfolios.

The Answer

The answer largely depends on what you believe. Consider the following principles of investing:

- Financial markets generally rise over long periods of time.
- Investors often make illogical decisions, selling when they should be buying and buying when they should be selling.
- Investing is one of the best opportunities the average person has to build wealth over the long term.
- Few (if any) investors have demonstrated a consistent ability to identify market peaks and troughs and time their investments perfectly in order to maximize profits and avoid losses.
- Corporations are in business to generate profits and will consistently seek to run their businesses accordingly.
- Inflation will diminish the value of your portfolio if your primary investment vehicle is one that yields 0% (the investing equivalent of putting your money under a mattress).
- Long-term planning based on your personal needs (or in the case of institutional investors, the needs of your organization) is the intelligent way to approach your finances.

If you believe all of the above to be true, and have conducted a thorough review of your long-term investment plan sometime during the last twelve months and found it to be sound, then we think your perspective should match ours.

Our View

The current problems with the global economy are cause for concern, but not cause for panic. Yesterday's decline of roughly 5% fails to rank among the top ten in terms of single-day declines (for the Dow, it doesn't even make the top 100), and the markets are still well above where they sat following last summer's cumulative 17% slide in the weeks after the end of the first round of quantitative easing in the United States.

While investors tend to focus on the markets when large declines translate into headline news, we focus on the markets every day. We realize that negative news is constantly being broadcast and that the global economy has yet to regain firm financial footing since the 2008 decline. We see that banks are being flooded with cash deposits (one major bank just announced that it will charge a fee to institutions making large cash deposits—guaranteeing a negative return on investment) and that

investors are buying short-term U.S. Treasuries even though yields on those issues are at historical lows.

We also realize that the financial markets have continued to advance. Over the past several years, our weekly, monthly and quarterly market commentaries have carried some variation of the phrase “we believe markets will continue to move forward, albeit in choppy fashion.” It has not looked or felt good to anyone, but investors who moved to cash when the markets crashed not only locked in the losses from the crash, but missed a significant rebound as well. Markets have moved forward and we expect them to continue that trend.

While there is fear in the media, not every outlet is buying into it. Bloomberg commented on the S&P 500 today, announcing that “Chief strategists at 13 banks, from Barclays Plc (BARC) to UBS AG (UBSN), see the benchmark of American equity surging 17 percent through Dec 31.” While SEI is not quite so bullish, we agree with the general sentiment and expect markets to close higher for the year than where they stand today.

With this perspective, there is no change in SEI’s positioning. While recent economic data have been weaker than expected, pushing most major global equity markets into official correction territory (peak-to-trough decline of 10% or more), we still view this as a mid-cycle correction, not the beginning of a bear market. The chief elements of our bullish view include:

1. Expansive monetary policy and a steeply upward-sloping yield curve in the U.S., U.K. and the European core
2. Low equity valuations
3. Continued strong corporate earnings growth in the U.S. and Europe
4. Robust economic growth in emerging markets despite tighter monetary policies and appreciating currencies

In light of this, we are making no extraordinary changes to our portfolios. Rather, we are continuing to make the type of reasoned, well-planned, active management decisions our clients would expect. For example, over the course of the last six months, we have taken a more defensive stance in our Core Fixed-Income Fund, allocating money to J.P. Morgan and Wells Capital. As credit spreads have contracted, we have systematically taken risk off the table, allocating more capital to managers that specialize in security selection. We have also moved assets to government-agency-backed mortgages and away from non-agency-backed issues. In our Large-Cap Fund, we just moved 10% of the assets away from Delaware Investments after its strategy delivered a significant gain and sent the majority of the assets to Brown Advisory. This move locked in gains from a strategy that worked well and redeployed the assets into a strategy that has not seen such a short-term run up.

Current Portfolio Positions

We believe the present environment is more characteristic of an economic “soft patch,” and recent headline events (Middle East, Japan, peripheral Europe, U.S. debt ceiling) are likely transitory in nature. This, combined with reasonably attractive valuations and a low inflationary environment, should support equity markets. On a strategic basis, we remain positive on equities versus fixed income. Within the equity strategies, we are generally positioned for a pro-growth environment (however, we are emphasizing large-company stocks over small).

With current yields so low, we feel total-return opportunities are somewhat limited within most fixed-income offerings. Given the risk of rising interest rates, we are modestly underweight duration. We

maintain an overweight to spread sectors (particularly non-agency mortgage-backed securities) and continue to favor the corporate and high-yield markets.

Regionally, we favor a tilt toward U.S. equity versus Europe and Japan owing to our view that the U.S. is further along in the business cycle and remains one of the more structurally sound markets despite the country's debt burden.

In the longer term, we expect markets to revert to the mean, with equities outperforming bonds.

What Would Change Our View?

Some signs that would make SEI's strategists and portfolio managers reconsider their positions are:

1. Economic sluggishness in the developed economies could tip into recession if a major shock materializes (e.g., another spike in oil prices, an unexpected slowing in Chinese growth, a near-term deepening of the European debt crisis).
2. Profit expectations may catch up with reality, raising the possibility of downside earnings surprises in future quarters.
3. Additional fiscal wrangling in the U.S. could create more market turbulence – the next battle is over specific funding bills pertaining to the 2012 Fiscal Year that begins October 1.

Personal Perspective

At a time when the world is in a state of alarm, SEI remains calm. You may be thinking, "That's an easy thing for a corporation to say, but my retirement money (or my pension plan assets in the case of institutional investors) has taken a big hit."

I would remind our clients that we stand beside you. Our firm's profits (and therefore our employees' livelihoods) are directly tied to the markets. When the markets fall, our assets under management fall in tandem. Since our profits are linked to the assets we manage, everyone at this company feels the pain when markets drop. There is no clearer way to say that your best interest and our best interests are one and the same.

We understand these are difficult times and thank you for your continued support and confidence in SEI.

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