



February 2012

Monthly Investment Commentary

Stock markets celebrated the New Year with a month-long rally as investors shook off fears of an imminent European recession and ongoing debt woes at home. This month’s “risk-on” mentality was apparent as assets generally perceived as riskier outperformed higher-quality assets in both the equity and fixed-income markets. Large-cap domestic stocks marched to a cumulative 4.5% return for the month, while mid- and small-cap stocks gained 6% and 7.1%, respectively. Domestic fixed-income delivered positive returns as well, with the broad high-quality bond index up 0.9% in January, while high-yield bonds gained 2.8% in the month.

Overseas, equity returns were also strong with emerging-markets stocks soaring just over 11% and international developed-market stocks gaining close to 6%. Emerging-markets bonds also posted strong gains, up 7.4% for the month, while international developed-market bonds returned 1.5%.

January Benchmark Returns (Preliminary)		
Large-Cap Benchmarks	Jan	YTD
Vanguard 500 Index	4.5%	4.5%
iShares Russell 1000	4.9%	4.9%
iShares Russell 1000 Growth	5.9%	5.9%
iShares Russell 1000 Value	3.8%	3.8%
Mid-Cap Benchmarks		
iShares Russell Midcap	6.0%	6.0%
iShares Russell Midcap Growth	7.2%	7.2%
iShares Russell Midcap Value	4.9%	4.9%
Small-Cap Benchmarks		
iShares Russell 2000	7.1%	7.1%
iShares Russell 2000 Growth	7.5%	7.5%
iShares Russell 2000 Value	6.6%	6.6%
Other Benchmarks		
Vanguard MSCI EAFE ETF	5.9%	5.9%
MSCI World ex USA Index	5.4%	5.4%
Vanguard MSCI Emerging Mkts. ETF	11.1%	11.1%
Vanguard REIT Index	6.5%	6.5%
Vanguard Total Bond Mkt Index	0.9%	0.9%
Merrill Lynch U.S. High Yield Cash Pay	2.8%	2.8%
Barclays 7 Yr Muni Bond Index	1.1%	1.1%
S&P/LSTA Leveraged Loan Index	2.2%	2.2%
Citigroup World Govt. Bond Index	1.5%	1.5%
JPMorgan GBI-EM Global Div. Index	7.4%	7.4%
DJ-UBSCI (Commodity Futures)	2.5%	2.5%

Research Team Q&A

We regularly use a question-and-answer format to address questions about our investment views and current strategy. This Q&A piece was worked on jointly by members of our research team and tackles questions received during the past several weeks.

Q: What are your thoughts regarding Gary Shilling’s arguments that despite recent uplifting economic indicators, the U.S. economy will slide into a recession in 2012 and likely spend most of the year in it?

Our analytical framework for assessing and estimating asset class returns is based on a five-year outlook across a range of scenarios and outcomes that we think have a reasonable chance of playing out. A U.S. recession within the next year or two is certainly consistent with some of our scenarios, including our most likely scenario of subpar growth due to debt deleveraging. However, we can't confidently predict whether there will be a recession in the next three months, six months, 12 months, or 36 months.

Looking more closely at some of the specific points economist Gary Shilling makes in his 2012 outlook, we find ourselves agreeing with many of them:

- Overall, he expects slow global growth over the next several years as a result of consumer, financial sector, and government deleveraging. We agree.
- He states that the deleveraging across these sectors probably has another five to seven years to run. We agree and we have explicitly factored that into our expected returns analysis for stocks over the next five years.
- He expects China to have a hard landing in 2012. We see that as a risk—but it is not our base case. And, again, we don't have a high level of conviction in putting a 12-month time frame on it happening, or even saying it will happen.
- Finally, Shilling expects Europe to have a severe recession in 2012. As we've repeatedly discussed, we are also concerned about the risk of a European financial crisis and the potential implications for economies and financial markets if it occurs.

The main difference is that we don't have the conviction to bet heavily on all of these macro events playing out in 2012. We believe there are other less severe scenarios that are probably more likely to happen. More to the point, the opportunity cost of being very heavily positioned for one extreme scenario can be very high if that scenario doesn't occur. As John Hussman once said, "it may happen, but it ain't gonna happen that way." Nonetheless, we are underweighted to equities in our balanced portfolios because our longer-term analysis suggests the risks from these types of macro headwinds are possible. While we are underweight to stocks, we do still maintain meaningful equity exposure, with the degree of exposure varying depending on the portfolio's risk/return objective.

Q: How do stocks stack up relative to bonds? What does Align think will happen to stocks if there is a recession?

At present, largely because of our concerns related to the developed world's deleveraging, we are about 7% to 10% underweighted to risk assets (depending on the portfolio), with the higher underweighting in our more conservative portfolios. This takes into account our emerging markets bond positions and the increase to emerging-markets equities we recently implemented in a few portfolios at the end of January. The second reason why we are underweighted to

stocks is that there are other investment alternatives (i.e. Gateway) that we expect to produce mid-single-digit returns, or more, with less risk than equities, over the same time period.

Stocks stack up well relative to bonds. In our subpar economic recovery scenario, we expect bonds to generate close to 0% over the next five years, annualized. So, on a relative basis alone, you could make an argument for overweighting stocks. However, we also have an absolute-return orientation to how we manage portfolios; we care about the 12-month downside risk we take on, especially in our balanced portfolios.

As we mentioned earlier, we do not invest based on only one scenario; our analytical framework for assessing and estimating asset class returns is based on a five-year outlook across a range of scenarios and outcomes that we think have a reasonable chance of playing out. While bonds are generally unattractive looking out five years across our scenarios, if a recession hits or deflation risks rise, stocks will have a lot more short-term downside than bonds. So, we think it is incorrect to make a positive case for stocks based on how they might do versus bonds and not factor in the risk side of the equation.

Regarding the question of what will happen to stocks if there is a recession, typically they go down a lot while bonds typically cushion the portfolio from stock declines. In the early 2000s recession, which was a relatively mild one, stocks went down about 45% before bottoming. In the most recent recession, stocks went down nearly 55%. How much stocks go down in the next recession is a function of the recession's depth, stock valuations levels, and companies' ability to offset revenue declines.

It is therefore difficult to know how much stocks will go down in the next recession. When stress testing our portfolios, we assume stocks decline 25% to 30% over 12 months. It is prudent, though, to prepare clients for a worse outcome and assess whether or not they are invested in the right portfolios.

Q: What will 2012 bring for Europe? If you think more trouble is in store, why are you still holding international stocks?

What 2012 has in store for Europe is largely an unknown because policy actions can have a significant impact on the outcome. We will briefly outline the two extreme outcomes:

On the optimistic side, investors stop clinging to the idea that the European Financial Stability Facility can be leveraged and put the crisis behind them. The optimists hope that the European Central Bank will initiate quantitative easing, buy sovereign bonds, and also address the insolvency issue of Europe's banks in time to prevent further crisis. At present, the European Central Bank's program of offering three-year loans to eurozone banks alleviates near-term liquidity pressures, which is a

positive, and reduces the likelihood of a 2008-like liquidity crisis. Optimists believe this is giving Europe time to figure out its debt crisis.

On the pessimistic side, which is where we lean, the recent fiscal compact does not address the real problems of competitiveness and lack of growth among the peripheral countries (such as Greece, Portugal, and Spain). Also, some of the key initiatives in the fiscal compact would be difficult to implement. One, you have 17 disparate nations representing different cultures, politics, economic conditions, and levels of competitiveness. This makes it hard to arrive at a consensus on big, complex issues such as “fiscal integration.” Second, it is politically difficult and economically unwise to implement austerity when some countries are already in a recession or depression. Third, European banks’ lending is severely constrained by the bad sovereign debt on their books coupled with the need for them to meet higher capital-adequacy standards in 2012. This ultimately will filter through to the real economy, impair growth dynamics, and may even bring about a recession in Europe. Without growth, austerity steps—may come to no avail. Ultimately, the pain could become unbearable for some countries and the eurozone could break apart in a disorderly fashion. That would be a very bad scenario for not only European stocks but for all risk assets.

We continue to hold international stocks for three reasons: First, while we are still concerned about a negative scenario, and that is why we slightly reduced our exposure to risk assets last year, we are not highly confident this outcome will play out. No one really can be, given the politics involved and the impact policy actions might have. We continue to analyze the situation carefully, though, and if our confidence in either scenario—optimistic or pessimistic—increases materially we’d take appropriate action in our portfolios. Second, our asset class work indicates that Europe has cheapened considerably and may be getting attractive, though not to a point where we’d overweight it. Third, we are seeing strong evidence from top international fund managers that they are finding attractive stocks to buy. There are a lot of examples where even companies with good fundamentals are being beaten down far below what they are intrinsically worth, so our value tilts (via DFA International Core) may add a lot of upside potential if and when the crisis stabilizes.

Q: With bond funds poised for little or no return over the next few years, why have you not considered recommending or using a dividend-yielding stock fund like Vanguard Dividend Growth or a dividend-paying ETF?

There are a couple of points to make here. First, most importantly we believe it is wrong to think of a dividend-focused stock fund as a replacement for investment-grade bonds in a balanced portfolio. From a risk perspective, this is comparing apples and oranges. No matter how poorly your return from an investment-grade bond fund might be over the next few years—and we do expect the returns of the

Barclays Aggregate Bond Index to be very low—an investment-grade bond fund shouldn't drop 20%–25% in a 12-month period. But that certainly could happen to a dividend stock fund in a severe bear market. For example, the Vanguard Dividend Growth fund lost 26% in 2008. Granted, that was better than the overall market, but it's still a large loss, and it compares to a 5% gain for the Aggregate Bond Index that year.

We own bonds in our balanced portfolios to moderate downside risk (consistent with each portfolio's 12-month risk target) and as a hedge against a deflationary shock or a recessionary economic environment—periods when stocks perform poorly and bonds typically do well. Therefore, if you are going to substitute some bond exposure for a dividend stock fund, you should be aware that while you are likely increasing the portfolio's longer-term return potential, you are definitely increasing your shorter-term risk exposure.

As we've discussed, this is not a time when we want to increase our equity risk exposure and we continue to underweight equities in our balanced portfolios. So, if one agrees with our point about the different risk levels of bond funds and dividend stock funds, you could still ask why we don't own dividend funds as part of our overall equity exposure—why not increase our exposure to dividend-paying stocks and reduce our exposure to other stock funds?

Our response is that we don't see the benefit or need to restrict a skilled equity investor's opportunity set with a dividend constraint. Our managers may consider a company's dividend yield and potential dividend growth as a component of their assessment of a company's intrinsic value, but it is not their exclusive or primary focus. From a tactical asset allocation perspective, we don't have a high-conviction, top-down view that dividend-paying stocks are compellingly attractive relative to the rest of the equity universe such that we would want to implement dedicated exposure to that subgroup within equities. So, we choose to delegate the stock selection decision at that level to skilled managers such as DFA.

Q: Can you give us an update on your research into REITs?

We do not believe that REITs justify a tactical allocation due to valuation, which we believe is rich and reflects expectations for a meaningful and persistent rebound in operating fundamentals. In our most-likely base-case scenario, we anticipate tepid demand for space as GDP forecasts continue to decline, while still-high levels of unemployment should dampen demand for property. In our view, job growth must accelerate to sustain a widespread recovery in REIT fundamentals.

The good news on the fundamentals front is that supply in the form of new construction remains subdued across all property types. Unlike prior real estate cycles, oversupply is not the key risk. This should help to support property fundamentals in the subpar recovery we're expecting.

While growth is one question mark, another risk we continue to see for REITs is a potential increase in interest rates. Our view remains that the decline in interest rates we've seen has been a key driver of higher property values, as property investors are willing to accept lower returns in an interest rate environment where 10-year, risk-free rates were recently below 2%. Today's low interest-rate environment will not last forever, and when rates rise, the low levels of returns investors are accepting today will be a thing of the past, putting downward pressure on property values and therefore REIT valuations. We should mention that in all of our economic scenarios we estimate that interest rates will move higher over our five-year investment horizon, with the magnitude of rate hikes dependent upon the specific economic scenario.

As rates do rise, it's also going to make REIT dividend yields less competitive as a yield instrument relative to other securities. For example, REITs' current dividend yield of 3.7%, while very low in absolute terms, could be perceived as attractive relative to a 2% Treasury yield. But any meaningful backup in rates will exert some pressure on REIT valuations. We suspect that REITs' relatively attractive dividend yield has been a driver of demand for REITs, and therefore REIT returns over the past year, as we haven't seen tremendous growth. This doesn't mean that REIT yields can't go even lower, but it's not our approach to speculate on short-term moves.

Q: You have mentioned in the past that you don't hold gold because you couldn't get comfortable with its valuation. Would you ever consider holding a position in gold based on the assumption that the global hyperinflationary money-printing program currently in place will continue to weaken currencies (and continue to drive up the price of gold)?

We continue to think about the potential role of gold in our portfolios. We follow its performance and read a variety of views and analysis on it. We have no plans to add it to our portfolios at this time, but that could change as our views evolve and markets fluctuate. The key problem we have with gold, as this question highlights, is that we don't know how to value it on a fundamental basis because gold has no yield, generates no cash flow, has no earnings power and therefore no "intrinsic value." We can't confidently assess what its "fair value" is (beyond looking at things like marginal production costs, which as we understand it are far below the current market price), and therefore we don't have a sense as to whether it is over- or undervalued, or what a reasonable return expectation for it might be over our five-year analysis horizon.

We understand that in this environment, gold is serving as a safe haven and as a hedge against developed countries' implicit desire to depreciate their currencies in order to stimulate exports and reduce their debt obligations in real terms. And, if we had to guess we would say we think central bank "money printing" or quantitative easing is more likely to continue over the next several years —than

that monetary policy will become more restrictive. So we can see gold's value in a portfolio as an "alternate currency" to fiat currencies (currencies that governments have declared to be legal tender, despite not being linked to physical reserves). While this currency role for gold is based only on perception and faith rather than some intrinsic value to gold, that faith has held through centuries and we're willing to bet that it will continue, at least for the foreseeable future.

More generally, gold has performed well in recent years, with some exceptions, in response to both inflation fears and deflation fears—in a sense, it is the fear of deflation that leads people to worry that the central banks' response will ultimately prove to be highly inflationary. Gold seems to be a hedge against general macro uncertainty, fear, and financial instability. We don't expect those issues to go away any time soon.

Of course, gold prices are highly volatile and one shouldn't expect them to always move higher even in the face of a financial crisis. For example, in the fall of 2008 the gold ETF fell roughly 25% while equities and other "risk-on" asset classes were also getting clobbered. Therefore, when we run our portfolio stress-test scenarios we are uncomfortable assuming gold would not again take a big hit in a financial crisis. As a result, we would likely want to fund a tactical gold position out of our "risk asset" bucket, rather than from bonds. But, we are already underweight to equities and are not looking to decrease the weighting further. And, as a dollar currency hedge, we like our emerging-markets local-currency bonds position, where we have a nice yield cushion and where we feel confident we can assess the risk and return in various scenarios—unlike with gold.

We are also somewhat wary of any asset that has had such a long run-up in price (11 straight calendar years of positive returns). Of course this doesn't mean prices won't continue higher but, again, it's unlikely we would be able to assess if gold prices were in a bubble because we can't put a fair-value range on it. Moreover, while we think the outlook for developed-market fiat currencies is likely to remain supportive of gold, we think the interest-rate environment is likely to become less supportive. As real interest rates rise (from their current very low/negative levels) the opportunity cost to holding gold increases. While gold has benefited from a positive cycle of higher prices and money flooding into the asset class pushing prices higher, we could certainly see that process working in reverse if this psychology changed.

Now, while we can say that we can't determine the intrinsic value of gold and that it only has value because for centuries people have believed it has value, we could say the same thing about determining the intrinsic value of a dollar or a euro or a yen. Fiat currencies only have value based on a common belief or faith in its value. Therefore, if you hold cash as part of your strategic portfolio allocation, it might make sense to consider holding some of it in gold as a long-term hedge against dollar depreciation. But, again, given its volatility we certainly wouldn't consider holding it in place of cash used for your emergency reserves or shorter-term liquidity needs.

Finally, we'd like to end with a quote from Jeremy Grantham, who we appreciate for his honesty. He's not a fan of gold as an investment, and his firm, GMO, doesn't hold gold in their asset allocation portfolios. Grantham recently said, "I own some gold myself as a pure speculation—just enough to mute the irritation of watching gold [prices] rise." That may be as good a reason as any.

As always, we welcome your comments or questions. We appreciate your trust and confidence. And, we pledge to do everything possible to continually earn it.

Sincerely,

—Align Wealth Management (2/8/2012)