CONWAY ÅJARVIS

Quarterly Investment Outlook

Volume 21 Issue 4 December 9, 2011

Fear Trade Hits the Pause Button for Global Investors in 2011

The emergence of the Global Economy and its markets has created both opportunity and risks for investors trying to cash in on the Industrial Revolution that's underway in the Emerging Market economies. More often that not, connecting equity portfolios to the fastest-growing economies in the world pays off in better-than-average returns. However, geo-political events or macro-economic concerns can strike fear into the hearts of investors, sending them scurrying for cover into markets where confidence trumps the expectation of return. 2011 was that kind of year. It was a "Risk-Off" year where the Fear Trade revived memories of 2008 for investors who shunned all things foreign, and, ironically, rushed into recently downgraded treasuries and the US equities markets. In effect, they were subscribing to Mark Twain's view that the return *of* their money was more important than the return *on* their money. In hindsight, 2011 will prove to be an anomaly when the political intransigence in the US and Europe succumbs to the demands of the global markets. Then, investors will once again have the confidence to leave home for a better return on their risk capital.

Where to Invest in the Global Economy

The emergence of the Global Economy has ushered in a new era of investing that presents an expanding number of choices in terms of products and individual securities. However, the most basic of investor decisions is WHERE to commit capital. Go back far enough in history and it was simple: the US and the New York Stock Exchange. Of course there have always been foreign exchanges but the US was the best of the best in those days. It was where investors could connect their risk capital to the fastest growing economy in the world. Times have changed with the developing economies now claiming that title. The Emerging Market economies have eclipsed the growth rates of both the US and Europe with China surpassing Japan as the worldôs second largest economy. The Industrial Revolution overtaking that region will continue for decades and savvy investors will connect to that growth.

With that as the over-arching theme of our portfolio strategy, direct foreign investment now makes up about a third of our equity holdings with almost all of the US-based companies that make up the balance deriving at least half of their revenues from abroad. An interesting pattern has emerged in the wake of the 2008 market crash: While there has been no directional decoupling of indexes between the Emerging Markets (ñEEMò) and the developed economies (S&P500, EAFE) there have been periods where the volatility and magnitude of returns have diverged significantly. The focus on macro-economic events and systemic worries has created a ñRisk-on/ Risk-offò trading environment where foreign exposure has been alternatively a boon and bane for investors.

The Why of Investing Abroad

Foreign investing has been a significant contributor to portfolio performance in the past decade but it comes with some excess baggage: Volatility. More often than not, weôve seen higher highs and lower lows in the EEM when compared to the major US indexes. For example, 2009 stock returns were generally clustered in the 28-32% range, while the EEM posted a whopping 74% return that year, almost tripling the gain of the next-best performing major index. That was a ñRisk-onò year following the first quarterôs self-inflicted near-collapse of the global finance system. 2010 proved to be a mixed bag of both Risk on/Risk off periods where we saw the EEM and S&P 500 finish the year with gains in the mid-teens and both within 1% of each other while EAFE lagged significantly, weighed down by Europe and its sovereign debt crisis.

When asked how the market is doing this year, our first response has to be ñwhich market?ò 2011 has been a decidedly ñrisk offò year for the global markets, occasioned by the disasters in Japan, the ñArab Springò that has unsettled the Mid-East, the fumble on fiscal policy and subsequent credit downgrade in the US, and a worsening sovereign debt crisis that almost assures a recession for Europe next year. As of the November close, we find US large-caps above water (S&P 500 up 1.06%) while ALL foreign indexes are in the red. Most noteworthy of these are the developed foreign markets (EAFE) and the EEM that posted losses of 13.92% and 19.37% respectively. Ouch!

Is that a reason to alter a long-term investment strategy and divert assets from exposure to foreign stocks? We donôt think so. Reducing exposure to Europe in the short-term might be a rational tactical response but not so for the Emerging Markets. Looking back on the past decade, we can conclude that EEM generally outperforms in Risk-on periods and under-performs when the Fear Trade takes over such as 2008 and this year when investors headed for cover into the perceived safety of US equities and its bonds. We couldnôt help but compare this summerôs scramble into low-yielding, recently downgraded treasuries to running back into a burning theater.

Embracing the Global Growth Story

To put 2011 in perspective: it will be only the second time since 2003 that EEM has under-performed the S & P 500. That index represents the fastest-growing economies in the world and will continue to for the foreseeable future. The Fear Trade will recede over time. Weôve already seen regime change in Greece, Italy, and Spain and will likely see a unified fiscal policy and governance structure for the Euro-zone approved in the coming months. The tilt toward fiscal responsibility in Europe will likely be reflected in the US but not before the elections in November of 2012. That said, we see the current trend favoring foreign investment continuing through the decade with brief interruptions from the odd geo-political or macro-economic event.

That leads us to remain believers in the Global Growth Story and investors in the Emerging Markets. Will the sovereign instability of the Euro-zone have an effect on foreign investment? Most assuredly. Europe has little hope of avoiding a recession in the near future. The ripple effect is likely to impact growth slightly in the Emerging Market economies since Europe is Chinaôs biggest customer. We believe the markets have overshot to the downside in pricing that effect into the EEM. With the US having 2-4 more years of a steady slog to full recovery, itôs almost inevitable that global growth will moderate. Despite that, the most compelling value proposition in the global economy remains in the EEM, followed closely by the US multinational companies that serve them. Thatôs why and where we recommend investors commit a meaningful portion of their risk capital.

Volatility: Get Used to It

We talked about the baggage that comes with investing in global markets these days. The interconnection of the global financial system and its financial institutions has brought about an unintended consequence: Unprecedented volatility. The kind that withers the resolve of even the most experienced investors. Currently, governments are making news that affects the markets, forcing investors to play catch-up using technology aided systems that act faster and with more volume than any human possibly could. While traders love volatility, investors generally view it as a condition to be endured or avoided entirely. The proliferation of hedge funds and bank-owned trading operations have brought record levels of volume and liquidity to the mainstream markets. Investment banks have also created markets in derivatives that operate in the shadows, tax the competency of regulators, and subject the underlying markets to conditions that make a stock exchange feel more like a casino. So why do investors subject themselves to the occasional stomach-dropping gyrations of the stock market? Because no other asset class offers the returns and liquidity of publicly traded equities.

The challenge for investors is to allow this volatility to work for them. It requires the discipline to follow a long-term strategy while being tactical when conditions dictate. In our view, this summerôs market gyrations didnôt portend of a return to 2008 and this yearôs under-performance by the Emerging Markets shouldnôt dissuade investors from pursuing growth where you find it. Our advice? Accept the volatility as part of the ride. We think youôll enjoy the destination but it may not always be a lot of fun getting there.