



# PERSPECTIVES

JULY 2009

NUMBER 44

## Second Quarter

## Talk With Us

**Quite a good quarter!** Thank goodness and about time. What a roller coaster we have all been on. Just months ago investors feared a replay of the Great Depression; now we have evidence that the worst is behind us and markets and the economy are healing. By no means is the economy improving, it is just not getting worse; we have bottomed.

The stock market rebound since March anticipated where the economy is now. To make further progress, investors need to have some sense as to the course and strength of the recovery. Since that is hard to assess right now, markets have paused. The consensus prediction is that economic recovery will be slow and labored. That may turn out to be the

case; however we are keeping an open mind to other possibilities.

The bond market has come a long way. From the fear induced safe haven in Treasury securities, credit securities of all types now are trading more normally. Rates on Treasury securities have moved up as some investors leave for better returns elsewhere and rates on lower quality credits have come down as opportunists plowed into capture terrific returns here. (Remember as demand and prices for bonds increase, the rate of return from the interest payment comes down.) Even junk bonds have had a terrific rally.

So far so good; what comes next?

After the recent bear market, many investors are asking, “**how can wealth be better protected?**” For a long time now, portfolio theory stipulated the need for an appropriate asset allocation model. Once an appropriate allocation was decided upon, change was rare. The idea was that investors or their managers should not respond to market changes, but merely rebalance periodically.

Changing asset allocation models usually implied that when times were good, investors would be more confident and increase riskier assets (such as stocks). The corollary would be that when times were bad they would reduce the proportion of riskier assets. This has the effect of buying high and selling low; buying more when prices are high and selling down when they are low. If the allocation were held constant, when riskier assets were doing well, some would have to be sold in order to return to the targeted proportion and what was not doing well would be purchased while they were cheap; (selling high and buying low).

However, when a massive bear market hits, that  
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**Notice**

*Riverplace Capital has an excellent website. We will use it to post interim comments from our president from time to time to help you keep up with our thinking as markets evolve and change. The site is under constant improvement, so take a look periodically at [www.riverplacecapital.com](http://www.riverplacecapital.com). We look forward to your comments. Also if we do not have your e-mail address, please supply it to [sharrington@riverplacecapital.com](mailto:sharrington@riverplacecapital.com) so we can forward market comments to you in this manner as well.*

### MAJOR INDICES AS OF 6/30/2009

Large Cap Stocks (S&P 500)	1.8
Dow Jones Industrial Average	-3.8
Mid Cap Stocks (S&P 400)	7.4
NASDAQ Composite	16.4
Small Cap Stocks (Russell 2000)	1.8
MSCI EAFE	5.6
Lehman Corp. Bond Index	1.73
Inflation	-1.3

(EQUITY INDICES ARE SIX-MONTH RETURNS EXCLUDING DIVIDENDS)

## Forecast

### Economy

We have predicted economic recovery and so far everything is unfolding as we would expect. However, what we cannot ascertain yet is the strength of the recovery. There are plenty of arguments for a slow, anemic one. However, there is the possibility that it can be much stronger than expected.

The stimulus poured into the economy from both monetary as well as fiscal policy has been enormous. Companies may have over-reacted to the down-turn by cutting inventories and employees too deeply and have to readjust by hiring and increasing production. There is some evidence that this is the case.

Since it is impossible to tell yet what is likely, we are positioned for either possibility.

### Equities

Stocks are likely to do well whether the economy recovers slowly or briskly.

Valuations are low, dividends are good and there is little competition from other asset classes. Real estate is unlikely to have another big round of investment. Bond interest rates are still low, money market funds and short-term investments pay almost nothing, and commodities are too small a market to absorb much new investment. In short, stocks are about the only game in town.

In addition, companies are likely to be more profitable than many investors currently expect. That is because so many of them have adjusted their cost structures quickly. Sales may be down, but many of them have been able to reduce expenses even faster. Labor and many material inputs also have come down significantly in price further improving their profit margins.

### Fixed Income

Treasury bond interest rates have already increased. Over time rates will

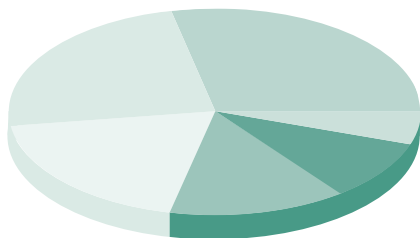
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## Forecast *(continued)*

rise further. They simply have gone too low. Money is leaving this safe haven as confidence improves and it seeks better returns elsewhere. Corporate interest rates may have already come down too much. Over the winter months, these bonds were selling at depressed prices offering very high returns, but now too many investors are trying to buy these, and rates and future returns are no longer attractive.

There are attractive rates in some of the more complicated derivative fixed income securities, but since these do not meet our criteria for safety and liquidity, Riverplace Capital is not pursuing these opportunities directly. However, we do participate through a very large fund that has expertise in this area and has the scale to absorb some mistakes.



static asset allocation model does not offer much protection. It may offer a relative improvement over an unbalanced account, but the decline can still be significant. Investment professionals are trying to adjust this model or come up with a better one that provides greater protection for accumulated wealth.

One approach being discussed is to make allocation shifts, but do so in a countercyclical manner; reduce riskier assets during good times and increase them during bad. This is a dynamic model and accentuates what the static model does by rebalancing down to a lower and more conservative asset allocation when prices are high. The downside to this approach is that investors may give up some upside return when it is available, with the hope that performance will be better during some future down period.

Just building a low volatility, high dividend paying portfolio did not work in this past bear market. These stocks went down just as far if not more than the market at large. Company and industry prospects change and this strategy tends to concentrate a portfolio in a few industries like utilities and financials, which may be undergoing fundamental change.

## *Talk With Us cont'd*

Another approach that some investors want to adopt is to reduce time horizons and merely trade stocks on a short-term basis. Unfortunately the historical record of this strategy is not good. It always looks easier than it is. Over time transaction costs act like the house in a casino, tipping the odds against investors. The transaction costs aren't just commissions, but the spreads between bids and ask and volatility in price that can work against investors, not just for them. There is an old adage that traders die broke and just like gamblers, most of them do.

Riverplace Capital is exploring how to put the dynamic model into effect. The critical factor is to provide the correct triggers for allocation changes. Do we adjust merely on index price change or do we use other factors as well? We believe we have identified several factors that should drive this trigger. These can not be so sensitive that volatility is increased rather than reduced.

Riverplace Capital works to build robust portfolios that can withstand downturns and reclaim, as well as, increase value in subsequent recoveries. We now are overlaying more robust allocation mechanisms to even better protect values and reduce volatility. If that is what you are looking for, then ***Talk with Us.***

## Investment Strategy

### *Equities*

Soon after the March market bottom, Riverplace Capital fully invested. We remain so. Our stock portfolios are biased toward business recovery; as they should be at the bottom of a business cycle. However, most of our recovery holdings have large portions of their business in new markets such as Brazil and China. That is because we simply see current growth in these markets and more growth potential in the future.

International growth has been an investment theme of ours for some time; we believe that it will now become even more important. We especially favor those companies based in the United States with our legal and accounting standards, but that have learned how to do business everywhere.

So far our stock portfolios are far exceeding benchmarks.

### *Fixed Income*

Quality bond yields are now too low. We have backed-off from making new purchases. We still look for singular opportunities, but these are few and far in between. We expect that interest rates will gradually move higher, so we are being patient.

### *Wealth Management*

In the spring of this year, we made some fundamental weighting changes to our diversified wealth management portfolios. Emerging market participation was added as the more developed international market participation was reduced. Longer-term Treasury bond holdings were eliminated as corporate bonds were increased. We created an even greater bias towards growth and away from value. So far these decisions are paying-off and these portfolios also continue to exceed benchmarks.

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