

Quarterly Market Review

By Nathan Behan, Senior Investment Analyst, CFA, CAIA

Financial Markets and Economic Analysis, Second Quarter 2010

Perspective: Ignoring the Short Term

What a difference just 90 days makes. In this space last quarter, we noted that despite the massive gains achieved in virtually every asset class over the preceding 12 months, the current market and economic environment was vastly different than that of the preceding year and the focus for the remainder of 2010 should be on individual company or security opportunities, rather than broad market exposures. The Greek debt crisis threw an All-Star quality curveball at the global markets and by the end of the second quarter left global equities in the red for the year. We certainly did not foresee the type of collapse in risk appetite that was engendered by the Greek crisis, but it serves as a reminder that the message shouldn't change whether the market is up 20% or down 20%: Market cycles come and go, but simply chasing the hottest assets (or fleeing the coldest) is not a long term winning strategy.

Granted, the sheer magnitude of the swings in market returns over the past 30 months has been gut wrenching and astounding to both the average and the professional investor. And it is exactly this type of volatile environment that costs the emotional investor the most in the long run. It is easy to understand the fearful reaction of any investor when faced with 30-50% losses (or more) in 2008. Likewise the euphoric reaction (or plain greed) of investors at the end of 2009 or the end of the first quarter of 2010. But letting the fear or joy of short term results drive an investment plan all too often leads to buying high and selling low, defeating the investor's goals. A solid, well thought out investment plan, adjusted appropriately for changes in individual circumstances not three or six month performance hiccups, is the best tool for reaching an investor's goals. Thus, our message to clients remains exactly the same this quarter as it did last quarter:

Investor focus for 2010 and beyond should remain firmly on current valuations and future prospects. GDP growth is widely expected to remain sluggish for most of the year and unemployment is similarly forecasted to remain at or near current levels. Given the current environment in both the domestic and global markets, this would seem to indicate to Prima Capital that the broad "beta" play in most markets has generally been eliminated, and universe ranking lists at the end of 2010 are likely to be dominated by managers who are successful in taking specific company or security risks.

Domestic Equity Markets Overview¹

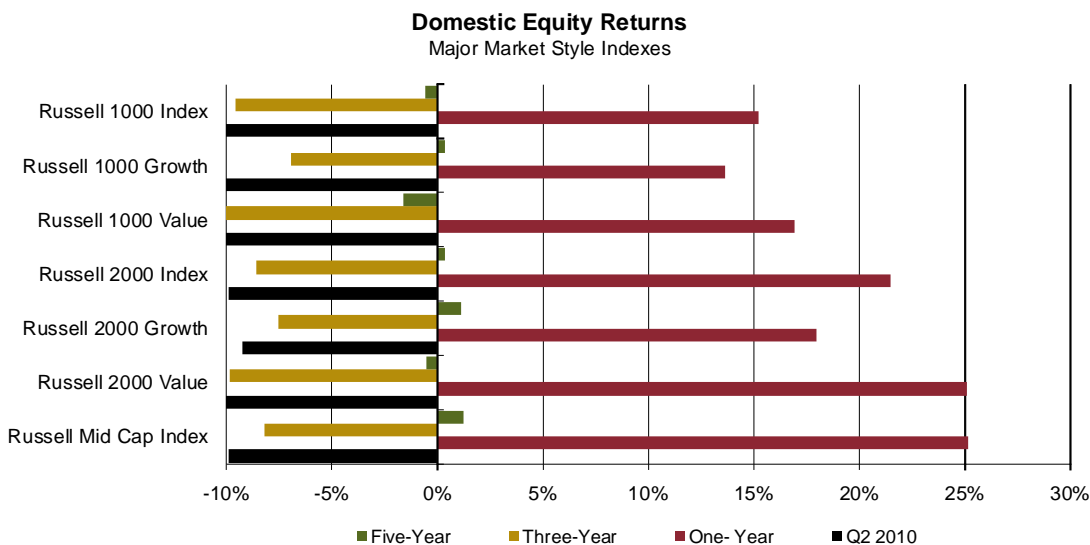
The second quarter opened up with high hopes and generally positive expectations for the remainder of the year. As noted in this space last quarter, there was a wide variety of opinions on the strength of the recovery, but few dissenters that a recovery was in fact underway. The Russell domestic style indexes exploded out of the gate in April, ranging from the Russell 1000 Growth Index up 3.6% to the Russell 2000 Value Index's 11.0% gain. This would however prove to be the peak for the quarter as rumblings from Europe sent investors scrambling for cover over the next five weeks and the indexes fell sharply over that period. For example, by the end of May, the Russell 2000 Value Index was down 2.0% for the quarter. Uncertainty continued to dominate the market in June with weak economic numbers in employment, housing and consumer confidence. The indexes were down again for the month ranging

¹ All index returns quoted from Russell Investment Group

from 6.6% for the Russell 2000 Growth to 8.4% for the Russell 2000 Value. For the quarter the losses ranged from 9.2% for the Russell 2000 Growth to 11.75% for the Russell 1000 Growth.

With risk aversion driving investors' thought processes it is unsurprising to find that the most conservative industries were the best performers in the quarter. Within the Russell 1000 Index the Utilities sector was the best performer, down just 3.8%, followed by Telecomm (-4.9%) and Consumer Staples (-8.5%). Among smaller companies, represented by the Russell 2000 Index, Utilities (-3.2%) and Consumer Staples (-6.4%) were the leaders.

At the end of the first quarter most managers were anticipating the end of the beta play in equities and were focusing on more fundamentally sound and higher quality companies. This was certainly the case during the quarter. The outlook for growth in the short term is mixed as the effect of last year's government stimulus begins to fade, the housing market appears to be recovering only sluggishly and unemployment remains high. However, some managers believe that the recent market pullback, combined with record low interest rates and high levels of cash on corporate balance sheets, has created the opportunity to buy these high quality companies at very reasonable valuations.



Source: Russell Investment Group (As of June 30, 2010)

International Markets Summary²

The international markets were roiled in late April when it appeared as though the Greek government was about to default on a significant portion of its outstanding debt. The Greek debt crisis not only shook the confidence level of investors and turned both the international and U.S. markets, but also had a big impact on the Euro which then further slammed returns for U.S. investors. The Eurozone markets were down anywhere from 4% (Germany) to more than 34% (Greece) in local currency terms. But the nearly 9.5% drop in the Euro relative to the dollar, pushed those returns well below the domestic market returns for the quarter. The developed Asian markets fared only slightly better, down 9% on average, with only Singapore showing a positive return for the quarter. The exchange rates had a much smaller impact in Asia as the dollar depreciated or held relatively steady with the key regional currencies. Most of the managers we spoke to this quarter are still heavily invested in Europe, as it makes up a significant portion of the market and the common benchmarks. However, the focus has not only shifted to the higher quality companies (much the same as the domestic managers) but also on those companies with significant export exposure to the emerging markets. Many of these managers are forecasting slower

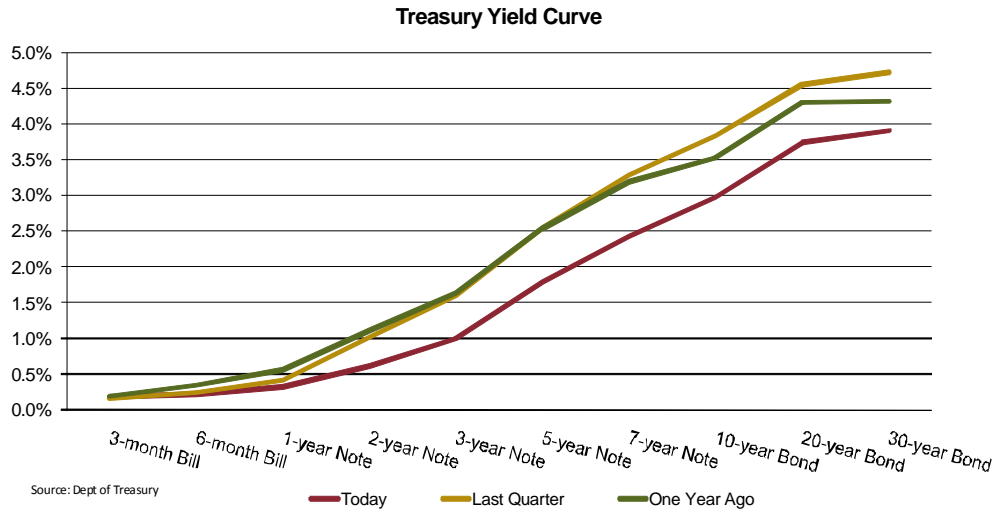
² All index return data and currency data is quoted from Russell Investment Group

growth in Europe than domestically, with the additional risk of a further debt crises possible among the common currency countries.

The Emerging Markets were much more mixed than the developed markets. While all of the major regions had negative returns, a handful of individual countries had positive returns, in dollar terms. These few bright spots kept the Russell Emerging Markets Index slightly ahead of the Developed Index, down just 7.71% in the quarter. As with all of the asset classes in the quarter, the emerging markets were heavily impacted by the flight to quality and those countries deemed most risky were heavily punished, particularly in emerging Europe. This de-risking process has been fairly indiscriminate, when considering many of these markets have higher growth prospects than the developed markets.

Fixed Income Summary³

The domestic taxable fixed income markets enjoyed a generally steady and profitable second quarter. The quarter was dominated by Treasury returns, particularly in those with the longest maturities. After a mild April, the Treasury market began to rally when the Greek debt crisis sent investors on a flight to quality. This rally continued through the end of the quarter resulting in a much flatter yield curve than just a quarter ago. The 2-10 year spread fell 46 basis points from 2.82% to 2.36%, primarily on the 87 basis point drop in the yield on the 10 year Treasury⁴. The Barclays U.S. Treasury Index was up 4.68% in the quarter and the 20+ Year Index up 14.97%. While the various spread sectors could not keep up with the Treasury returns, they were also positive for the quarter. The U.S. Corporate Index was up 3.42%, despite a small loss in May, and the MBS Index was up 2.87%. Given the relative underperformance of the spread sectors in the domestic market, we would expect most active fixed income managers to have underperformed in the quarter. The high yield market was the one exception in the second quarter, as the Barclays U.S. High Yield Index was down 11 basis points. The Index couldn't rally from the sharp losses in May (another impact of the Greek debt crisis) and was dragged down substantially by the CCC and lower rated credits. These are the very same credits that drove returns in the latter part of 2009 and in the first quarter of this year. The BB and B rated segments of the Index actually had modestly positive returns for the quarter.



³ All index return data quoted from Barclays Capital

⁴ Yield Curve data quoted from U.S. Treasury Department website

Municipal issues had a somewhat disappointing quarter after getting off to a strong start in April. The Barclays Municipal Index finished the quarter up 2.03%, but was up just 6 basis points in June. Municipal bond prices were essentially flat for shorter maturities for the month and down 40-65 basis points in maturities greater than 10 years. The Barclays 10-Year Municipal Index was the best performer for the quarter at 2.68%. The municipal market's underperformance relative to the Treasury market in the second quarter is in part attributable to rising concerns over the credit quality of state and local governments. In addition, the municipal market does not typically benefit from a global flight to quality at the same level the Treasury market does, which was likely responsible for a significant portion of the performance differential.

The events of the second quarter have significantly changed the economic outlook for many of the managers Prima Capital has met with during the past 90 days. Where many forecasts were calling for the Fed to increase rates during the first quarter of 2011, and for the market to anticipate the move by several months, the most common outlook today is for the Fed to be on hold throughout the remainder of this year and through the first half of 2011. And while the consensus view remains for muted growth in the U.S., we are hearing more concern for a "double dip" or second recessionary period. Despite weak U.S. growth and recent massive issuance, Treasuries remain the "safe haven" for global investors, and could benefit significantly from such a scenario, or another major financial crisis.

Outlook

The final two months of the second quarter completely wiped out the market gains of the first four months in the global equity markets and investors have once again dramatically reduced risk exposures in their portfolios. Economic forecasts continue to predict low but positive growth with little inflationary impact, held back domestically by high unemployment and high levels of excess capacity. Corporate balance sheets continue to improve leading to the potential for significant merger and acquisition activity in the second half of the year. But as the massive global stimulus from 2008/2009 begins to fade, the transition to organically supported growth has been tenuous so far. Turmoil, doubt and downright fear has created an environment in which investment managers with steady nerves, sound investment processes and a little foresight can significantly reduce losses in the short term and position their portfolios for significant gains in the long term.

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