

# THE PRIVATE WEALTH ADVISOR

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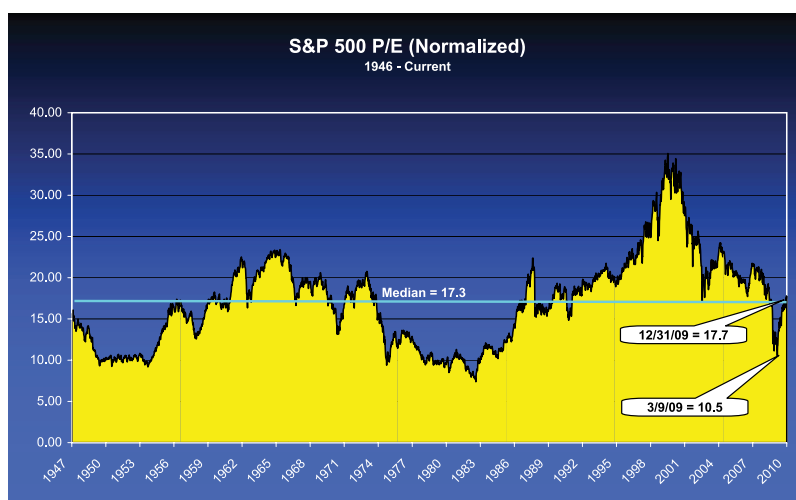
*Nurturing Portfolio Growth*

by John M. Schneider, CFP<sup>®</sup>, President

In the spring of 2009, we recapped what had turned out to be an absolutely dreadful decade in terms of investment in the broad stock market. At the same time, we attempted to shift focus from the obvious pain of the drastic stock market decline to the immense opportunity which has resulted from the fall. The purpose of this piece is to update our clients on our research and disseminate our views on the markets. In the spring of 2009, our research showed that the stock market was as cheap as it had been in a quarter century. Owning stocks at such a low valuation would almost certainly result in large gains for portfolios.

The bounce off the market bottom (March 9, 2009) was rapid and the magnitude was great. From such low levels, owning stocks (or other “risk” trades like high-yield bonds) produced excellent results.

### ● Conviction to own the “cheap” market



Source: The Leuthold Group, Inc.

As the market sell off ended in early March 2009, the normalized P/E ratio of the S&P 500 nearly fell into single digits (bottoming at 10.5). We commented that this low reading (seen last in 1984) was a 40% discount to the long-term average valuation on the broad market. This compelling valuation combined with low interest rates and government intervention presented an opportunity to maximize upside potential within portfolios. “This entails a shift from defensive names toward cyclical sectors of the market.” We believed technology was the best opportunity and listed numerous reasons why.

The way the final nine months of 2009 played out proved our market positioning to be correct. The market was cheap, but it would not remain that way for long. The equity market roared off its bottom, with the S&P 500 Index gaining over 35% in the first two months of the recovery. For the year the S&P 500 Index gained over 26% which was a very good year considering the market lost 25% up to March 9th. This rapid rise, while broad in scope, was driven primarily by large technology stocks. The sector returned approximately 60% for 2009, 15% ahead of the next best sector and far beyond numerous segments of the market.

As the equity market moved higher in 2009, so did the valuation of the broad market. By year end (as shown in the chart labeled “S&P 500 P/E”), the P/E ratio of the market stood at 17.7, in line with the long-term average. Some may view the increased valuation as cause for concern, but in our opinion equities are still attractive.

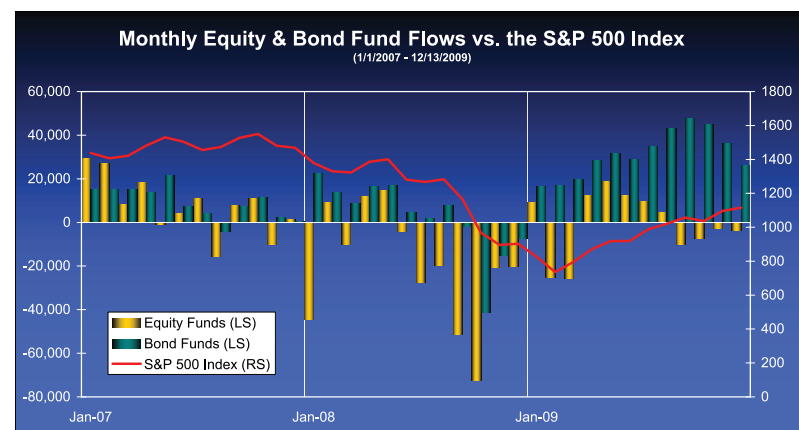
### ● The path of a market recovery

While each market recovery is unique, over time, a pattern develops. Studying 100 years of bear market recoveries, on average, the first full year from a market bottom produces a 47% market return. The return is typically less after a milder decline, more after a severe decline. Given the severity of the drop in 2008 and the first part of 2009, a first year recovery average of 63% may be more reasonable.

## EXECUTIVE EDITORIAL

In March of 2010 we will move into the second year of the recovery. Historically, while not nearly as impressive as the first year, there are gains to be had. The average second year of a recovery is close to 9% as investors become more comfortable. This would be very close to an average year in the stock market. With valuations at the long-term average, this is the type of year we expect.

### ● A continued lack of market conviction



Source: Morningstar, Inc.; Investment Company Institute

As the graph depicting equity and bond fund flow shows, there was little fear about stocks in the first half of 2007 even though equity market valuations were historically rich. As the market sold off in the fall of 2007 through the spring of 2009 (dropping 50% in that time), investors quickly exited both stock and bond holdings in favor of cash positions.

The sell off lowered the market P/E substantially. Even with the low P/E, retail investors continued to sell equities for much of 2009 (choosing a rebounding fixed-income market instead). Retail investors chose to purchase bonds during a period where the stock market gained over 66%. Retail investors often chase the hot asset class. There was clear hesitancy to buy the “cheap” market in 2009, even as news improved in the fall. The contrarian view, buying during periods of fear where value can be had, is not something the retail community has adopted. Money will flow to equities, but probably not until investors feel comfortable. This often is a time when the market becomes expensive.

### ● How do you approach 2010?

Expect a high single digit/low double digit stock market return as 2010 will likely follow the trends of the typical second year of a market recovery.

A pullback is probable before new highs are reached. This will create the opportunity for those on the sidelines to enter the equity markets and move stocks even higher.

Continue to own technology stocks, but take profits to add to the left behind categories listed below. Tech earnings and guidance have been strong. Their global businesses are attractive, as is their growth. The sector should remain a core holding, but no longer a significant overweight.

Focus on high quality, non-cyclical sectors such as health care, consumer staples, telecom and utilities. These stocks did not fully participate in 2009's rally and are attractive given the expectations for the year.

## ● Growth vs. Value

In 2009, large growth stocks outperformed large value stocks by 10.4%. Large growth stocks, led primarily by the technology sector, dominated large value stocks. Recent performance has not changed the trend as large growth outpaced large value in the last two months of the year by over 2%. Large growth stocks currently trade at 1.69 times the P/E ratio of large value stocks. Historically they have traded at 2.31 times the P/E of large value stocks, making large growth stocks approximately 27% undervalued in comparison to large value stocks. Lower market capitalization showed signs of stress in 2009, but had a strong finish to the year. Small growth stocks were nearly 14% ahead of small value stocks for the year. Currently, small growth stocks are 15% more attractive than small value stocks based on valuations.

## ● Large vs. Small/Mid

Small cap stocks struggled compared to their large cap counterparts for most of 2009, but closed the gap in December. Large U.S. stocks were essentially even with small cap U.S. stocks in 2009. Based on historic relative valuations, small cap stocks currently trade on par with large caps. This relationship puts the asset class approximately 17% above their fair valuation versus large cap stocks over the past 35+ years. Reduced exposure to what may be continued weakness in the U.S. dollar, and the possibility of higher future interest rates continue to make small caps unattractive.

## ● U.S. Equity vs. International Equity

The discount for developed international stocks versus large U.S. stocks virtually disappeared throughout 2009. The MSCI® Index finished 2009 5.3% ahead of large U.S. stocks. Large international stocks are presently just 2% undervalued based on their historic comparison with large U.S. stocks. European stocks have performed well as the market rebounded in 2009. European stocks beat Pacific stocks by over 11% last year. This disparity is largely due to Japan's poor performance, up just 4.44% for the year. Pacific stocks, without Japan, were up over 65% in the same period. European stocks are undervalued compared to Pacific stocks. Emerging markets put together a stellar year, up over 78% in 2009. These stocks look slightly expensive versus U.S. large cap stocks, but slightly inexpensive versus large, developed international stocks.

## ● High-Yield vs. Treasuries

The interest rate spread between high-yield bonds and Treasuries fell drastically in 2009. High-yield bond owners currently receive a yield premium of 5.47% over 10-year Treasuries, which is 0.37% above the long-term

mean relationship. Spreads continue to fall back toward the historical mean of 5.10%. While the yield benefit of owning high-yield bonds has declined throughout the year, so has the threat of massive defaults. Default expectations for 2010 have been lowered, with some predicting sub 5% defaults.

## ● Municipal vs. Taxable

Municipal bonds performed very well in 2009, outpacing the BarCap Aggregate Bond Index by nearly 7%. While taxable government bonds were not overly attractive in 2009, investment grade corporate bonds performed well (up nearly 16%). Municipals remain an attractive option for bond investors, particularly for those in high tax brackets, given the likelihood of higher income tax rates in the future. Historically municipal bonds trade at 85% of the equivalent maturity Treasury bonds. As of year end 2009, they are priced to yield 103% of the 4.65% 30-year Treasury bond.

## ● Interest Rates and the Yield Curve

While the Federal Reserve has kept the short end of the yield curve low, rates on the intermediate, and long end of the curve are up substantially from a year ago. As investors' appetites for risk increased in 2009, the demand for Treasuries eased somewhat, allowing longer rates to move higher. Currently two-year Treasuries are yielding 287 basis points less than 10-year Treasuries. Spreads between two-year and 10-year Treasuries have remained consistent in recent months. Since 1980, 10-year Treasuries have typically yielded approximately 70 basis points more than two-year Treasuries, placing the current level significantly above the norm.

## ● Inflation

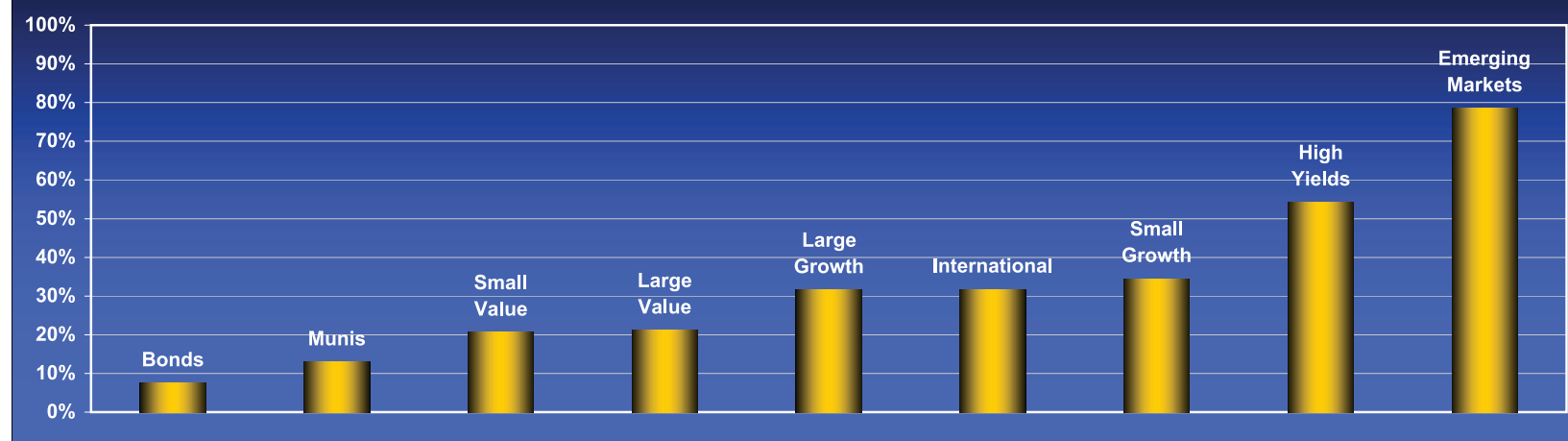
By year end 2009, The Leuthold Group expected a transition back to mild inflation (approximately 3.3%) as tracked by the Consumer Price Index. This was largely due to the elimination of the deflationary numbers experienced in late 2008. The same general story was true for the Producer Price Index, looking for 3.5% inflation. The weak dollar has been a large contributor to higher commodity prices during the recovery.

## ● Real Estate

REIT performance was strong as the market recovered in 2009. The category finished the year over 28% higher. Money flow to real estate focused mutual funds reversed and finished 2009 near the low levels for the year. This was surprising, considering the recent strong performance of the asset class. Valuations for REITs have moved higher since March 2009 and have moved into expensive territory. REITs are currently 22% above their long-term average valuation.

## YTD Asset Class Performance

(as of 12/31/09)



Source: Morningstar, Inc. The following proxies were used to measure performance for their respective categories: Small Value = Russell 2000 Value; High Yields = Credit Suisse HY; Munis = BarCap Municipal; Large Value = S&P 500/Citi Value; Small Growth = Russell 2000 Growth; Bonds = BarCap US Aggregate; Large Growth = S&P 500/Citi Growth; International = MSCI EAFE; Emerging Markets = MSCI EM. Returns include reinvested dividends, capital gains and other earnings.

# Transition Time

- Focus on the well capitalized technology sector paid off in 2009 as the sector was, by far, the strongest in the U.S. equity markets.
- Some market sectors (health care, consumer staples and telecom) did not fully participate in the market rally of 2009.
- A partial shift in funds from more cyclical segments of the market to areas with fundamental value is prudent as the market rally matures.

It is a common story. Found in novels, on television and even on the silver screen. A troubled youth with a checkered history is taken in by a caring family, looking to help him turn his life around. Friends and neighbors are initially concerned about the family bringing this person into their lives. As time passes, people become more accustomed to the kid and begin to accept them into their community. In turn, the kid begins to feel like a part of something bigger than himself.

Unfortunately, this harmony does not last. Something happens. Maybe something valuable is stolen. Everyone jumps to conclusions, and the easiest conclusion to draw is the kid with a history of trouble found trouble once again. No questions are asked. Assumptions are made instead. The sins of the past are revisited in order to pass judgment on the kid in the present. Often times in these stories the judgment is incorrect. Only later, as the truth comes out, is the kid vindicated in the eyes of those who judged him so harshly.

Technology stocks have their own demons to exorcise. After their breathtaking run from the mid

1990s to 2000, tech stocks became immensely overvalued. The problem was, few could see past the sizzle of their lofty returns to realize how expensive they had become. So investors held onto these stocks. Some even bought more, hoping for a continued run which would result in even more gains. The next three years brought few positives for tech stocks. Instead, investors lost a substantial portion of the money they invested. For three years a significant chunk of the investment community suffered at the hands of the stocks they hoped would make them rich.

The subsequent five years were relatively strong years for the market, and technology companies found a better footing with more realistic expectations from investors. And they delivered, both in terms of profits and in terms of returns. Then the markets crumbled in 2008. This time the collapse resulted from a liquidity crisis brought on primarily by financial institutions and their complicated investments built around mortgages. As the markets tumbled, led by financial stocks, technology companies were pulled much lower. While tech stocks should have fallen along with the broad equity market as all sectors of the market traded lower, the proportion by which they fell did not equate to the stocks' fundamentals. Investors remembered how these stocks acted in the previous bear market, as the tech bubble popped and reacted to those memories by disposing of the stocks they feared to be volatile in the most current downturn.

Unlike banks and other financial institutions that had exposure to unknown losses tied to mortgage products, technology stocks had a lot going for them in 2008. Top technology names such as Apple, Cisco, Intel, Microsoft and Oracle were just completing a five year run where they had at least doubled their revenue and significantly increased their net income.

These companies were also in a much better position than most companies in other sectors due to their high levels of cash. This cash provided a safety net as well as giving them flexibility to take advantage of opportunities the market created. Some companies chose to use the cash for share buybacks, purchasing severely discounted shares. Others used the cash to purchase other

technology companies: not all companies were in such strong financial positions given the downturn, leaving them vulnerable to acquisition.



While earnings fell for these large technology names, the drop in earnings was not as significant as the fall for other cyclical sectors of the market such as industrials and consumer discretionary. The drop in stock prices was much more substantial than the drop in earnings, plus valuations for the sector were cheaper than they had been for the better part of fifteen years (even removing the lofty tech bubble valuations). With attractive valuations and solid financial footing in the technology sector, Private Wealth Advisors (PWA) increased its exposure in 2008 and in early 2009. In the spring edition of "The Private Wealth Advisor" we discussed the above and stated, **"We believe technology stocks offer the best opportunity for outperformance when the stock market rebounds, precisely because they have better profit fundamentals."**

After a difficult start to 2009, the equity markets rallied from early March lows. While many of the ravaged financials and other cyclical sectors initiated the move off of market lows, technology joined the rally and moved significantly higher. Unlike these other sectors of the market which witnessed extreme declines in revenue and earnings, technology stocks had the fundamentals behind them. While the technology sector held its own off the market bottom, the stocks many referred to as "junk" moved the most quickly off the lows as investors looked for the largest initial recovery move.

Although sectors like financials and industrial stocks enjoyed an impressive run from the spring into the summer, they were severely beaten prior to the rally and had a long road to recovery. From the peak of the market in October 2007 to the bottom in early March 2009, the financial sector fell an astounding 81.7% as losses mounted for the banks. Industrials suffered as the global economy came to a screeching halt, losing nearly 64% in the same time period.

The decline in technology, while still great at approximately 50%, was the least of all cyclical sectors of the market. Their more resilient earnings (compared to other cyclical market sectors) set the stage for a strong price recovery. Those investors willing to add to their tech exposure were given an opportunity to accelerate the recovery of losses from 2008.

Technology's rally in 2009 may have started with participation as cyclical stocks moved off

SECTOR VALUATION (as of 1/13/09)	
VALUATION	SECTOR
OVERVALUED 	MATERIALS
	ENERGY
	FINANCIALS INDUSTRIALS
FAIR VALUE	CONSUMER DISCRETION
UNDERVALUED 	TELECOM / UTILITIES
	INFORMATION TECHNOLOGY
	HEALTHCARE CONSUMER STAPLES

Source Data: PWA Research, Baseline

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## Transition Time

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the bottom, but by the fall of 2009 it turned out to be much more. As earnings season unfolded, technology delivered in terms of real numbers. Companies like Microsoft, Intel, Cisco and Apple delivered excellent quarters and provided a strong outlook for their businesses and the sector moving forward. This news helped to propel technology even higher. By year end 2009, technology was the best performing sector for the year, up over 60%. Technology more than doubled the performance of every other sector of the S&P 500 Index, with the exception of consumer discretionary and materials.

While the outlook for technology still appears rosy, **PWA is shifting funds within equity portfolios toward the traditionally more defensive sectors of the market.** As this rally becomes more mature, sectors which have not fully participated in the recovery thus far but have solid fundamentals should at least keep pace as the market moves at a more modest rate.

Using the last recovery (starting in 2003) as a proxy, this thinking holds up. In 2003, the market bounced 32% off the bottom. The subsequent two years delivered returns for the S&P 500 Index of 9% and 3% respectively. Energy is pulled out of the analysis since it quadrupled the return of the next best sector in that time. Aside from energy, returns for the major market sectors ranged from 16% (industrials) to 3% (technology). Consumer staples and health care fell right in the middle of the pack – below industrials and financials, above consumer discretionary and technology.

Based on the last market cycle, a broader participation seems likely in the recovery's second year. The argument grows stronger considering both staples and health care enter the second year of this recovery with much more attractive valuations than we saw at the start of 2004. Today, for example, staples trade at a 20% discount to the broad market. In 2004 they were at a 10% premium. This suggests there is room for upward revaluation to drive prices higher over the next couple of years.

Conversely, the cyclical sectors look stretched. With the third quarter earnings season over and the economy growing at 3-3.5%, analysts have raised profit estimates for 2010. Using industrials as an example, the sector expects income to grow 75% over 2009. Even with cost cutting and international growth, it seems like a tall order given U.S. economic growth expectations. The stocks, however, are fully discounting that level of earnings recovery. Those industrial stocks have an average forward price/earnings (P/E) ratio of 32. Meanwhile, the P/E on a less cyclical sector like health care is 12.

Historically health care has traded at a premium to the broad market, so today health care is as cheap as it has been in the last decade. Quality companies like Johnson & Johnson, Abbott Laboratories and Amgen trade at below market multiples. While some companies in the sector (particularly drug firms) have growth challenges as patents expire and the government tries to reign in health care costs the news is not all bad. If thirty million people acquire health coverage through government efforts, they become regular users of products and services instead of occasional emergency room visitors. In addition, the baby boom generation will gradually inflate the size of the elderly population. This segment of society spends heavily on health care devices, drugs and services. So far negative forces have kept stocks prices for the sector down. **PWA sees this as an opportunity going forward.**

The story is similar for consumer staples. These stocks also are typically valued higher than the broad market due to their stable, predictable cash flows and dominant global brands. Today it is not the case. As investors have flocked to deep cyclical names with operating leverage, they have left companies like Coca-Cola and Procter & Gamble at just 15 times next year's earnings.

This seems out of proportion. These stocks *do* offer growth potential. Coke derives 75% of sales from foreign sources. Last quarter unit volume grew 15% in China and 30% in India. A premium brand like Coke is exactly the type of product that should benefit when living standards rise in emerging nations.

The same is true with household goods, where U.S. brands in product categories such as toothpaste, detergent and shampoo are already well established in the emerging world. Colgate Palmolive, for example, holds 30% of the toothpaste market in China. That type of market share is a major advantage when attempting to grow in the overall market. **These types of opportunities make the consumer staples sector attractive today.**

2009 TOTAL RETURNS by SECTOR	
INFORMATION TECHNOLOGY	61.72%
MATERIALS	48.59%
CONSUMER DISCRETION	41.30%
INDUSTRIALS	20.93%
HEALTHCARE	19.70%
FINANCIALS	17.22%
CONSUMER STAPLES	14.89%
ENERGY	13.82%
UTILITIES	11.91%
TELECOM	8.93%

Source: Morningstar

There is also less risk in the less cyclical sectors should the market decline in 2010. While GDP numbers are rising, much of the growth is due to government stimulus and a rebound in inventories throughout the economy, and commercial real estate could cause another flare up in the financial sector. The defensive segments of the market are more insulated from those issues.

While PWA still believes in large technology stocks, at this point in the rally it makes sense to add to the fundamentally sound but essentially forgotten sectors of the market and, specifically, high quality, dividend oriented companies. They offer stable earnings and the dividend aids the total return for these stocks. While health care and consumer staples stocks were addressed above, sectors like telecommunications and utilities can also have a place in this strategy. In the rally's second phase, it is much more likely that high-quality stocks will be the drivers. ●

*At the time this was written, the following stocks mentioned in the article (Colgate, Palmolive, Procter & Gamble, Coca-Cola, Amgen, Abbott Laboratories, Johnson & Johnson, Apple, Cisco, Oracle, Intel and Microsoft) were owned by clients of Private Wealth Advisors, Inc.*

# Domesticating the Emerging Markets —

- *Emerging market equities led the way as the market recovered in 2009.*
- *Valuations for emerging market equities appear a bit rich today.*
- *Economic growth remains very attractive in emerging economies, but the best way (in terms of risk/reward) to capture the growth is through large, multinational companies with substantial business exposure to these areas.*

Microsoft was not always the \$250+ billion market giant it is today. In the mid 1970s, it was essentially the marriage of two revolutionary ideas. When Bill Gates convinced Micro Instrumentation and Telemetry Systems to distribute his BASIC programming language with their microcomputer, Gates high tailed it from Harvard to New Mexico to launch Microsoft. The company did not enter the publicly traded market until about a decade after the company's formation, but when it did its impact on the market proved to be very significant.

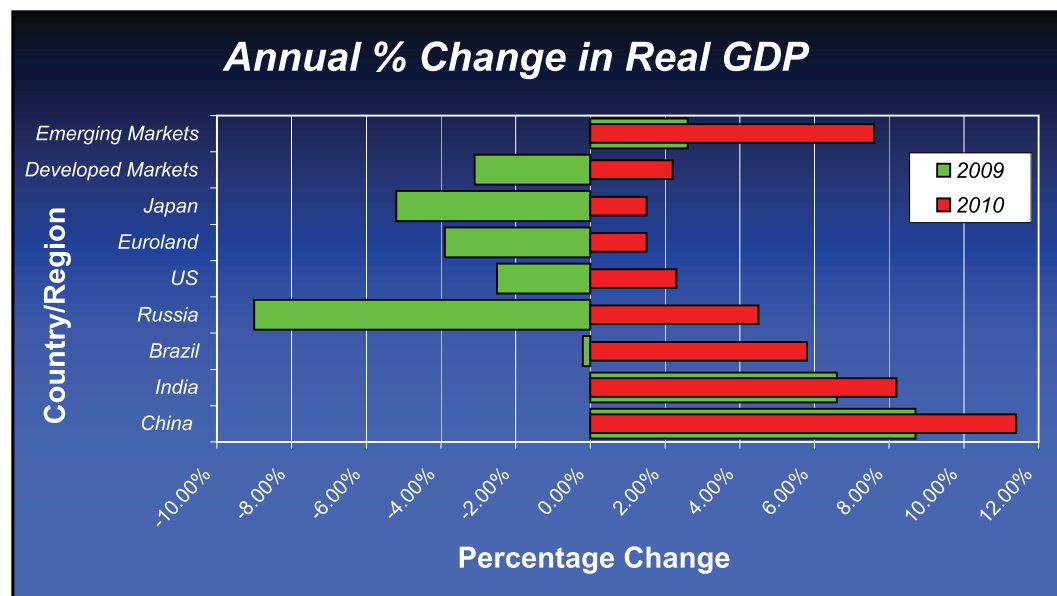
As Microsoft's new technologies took hold in the marketplace, its stock price (along with the stock of other new, emerging technology companies) skyrocketed. It began at a split adjusted price of under ten cents per share, and it nearly hit \$120 per share in 1999 (near the end of what would later be known as the tech bubble). The popularity of the new technologies coming to market and the continued innovation of these rapidly growing companies drove the overall market to heights it had never witnessed before. It was not the mature, developed companies leading the market growth. It was the once fledgling, now emerging companies carrying the market on their surprisingly broad shoulders.

Parallels can be drawn between the impact of small individual companies' path from start up to mature market heavyweight and the metamorphosis of a country moving from somewhat of an afterthought to a key cog in the world economy. The similarities are clear when looking at what a country like China has meant to the global markets in recent years, including a very strong recovery in 2009.

China's economy offers several advantages many of the world's developed economies do not. It has its vast population working in its favor. China's means of production far outweigh those of its industrial competitors. The gap in wealth has been closed as China has essentially become the manufacturer to the world. This has put China in a very strong position compared to

developed nations, especially the United States. While the U.S. has become more and more in debt over time, China has moved in the opposite direction. Now China has the world's largest foreign exchange reserves. Finally, China's domestic demand is rapidly on the rise. Given its population size, and despite its low per capita consumption levels, China is the largest consumer nation in the world. This rising domestic demand, over time, will make China less susceptible to the economic declines in other parts of the world.

In 2009 China's stock market quickly bounced off the spring bottom and returned nearly 60% for the year. Surprisingly this was not the most impressive broad return for the year. The MSCI Emerging Markets Index was higher by almost 75%, meaning other emerging nations' stock returns actually outperformed China in 2009. These returns are staggering when compared to those of the developed economic leaders. The United States returned just over 26% for the year. Europe was slightly better at about 27%, but the returns in local currency were less than 23%. Japan was the most disappointing, returning less than 5% for the year. **Despite these lofty returns exhibited by the emerging market countries, Private Wealth Advisors is using caution in this segment of the market and looking to large multinational companies for added exposure.**



As the entire global marketplace was under siege in the final months of 2008, China's government was more proactive than many of the world's traditional economic leaders. With such large foreign reserves, China's government could afford to open its coffers. Programs were implemented to expand hospitals and pension programs, improve schools and strongly encourage lending from banks to Chinese consumers. These actions put China at the forefront of the global economic recovery, and it showed in terms of stock returns in its market.

Given the results, emerging market equities are very enticing, and there are reasons beyond the results which make the assets class attractive in portfolios. Primarily, the growth in these regions is outstanding. Even at its worst times during the most recent pullback, China's GDP was not expected to decrease below 6%. Today, projections for 2010 stand at 11.4%, a much different story compared to many of the developed market countries which witnessed negative GDP growth for a period of time.

China is not the only rapid grower in the emerging market category. The category, on the

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## Domesticating the Emerging Markets

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whole, has a projected GDP growth rate of 7.6% in 2010 and 7.3% in 2011. These numbers dwarf those of the developed markets. For the next two years, the United States GDP estimates are 2.3% and 2.4%. Europe and Japan are even more meager, with both looking at 1.5% - 2% growth in the next two years.

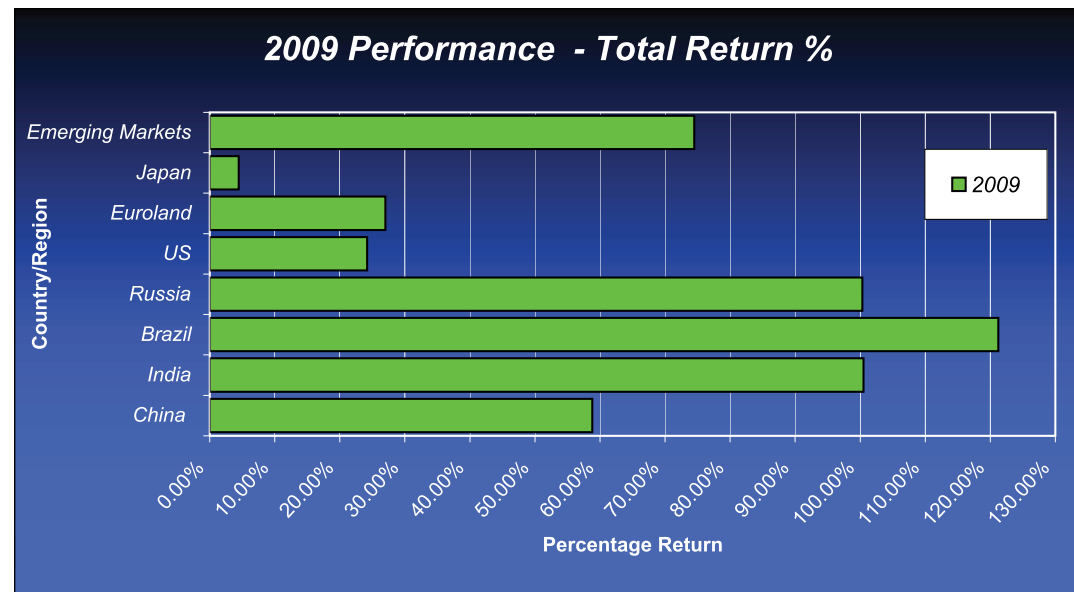
Given the stark contrast in growth projections, why not place a substantial portion of a portfolio's equity allocation in emerging market investments? Two factors should give pause if considering a large overweight to the asset class. First, emerging markets have historically been very volatile. Even though volatility has come out of the market during the last part of 2009, most can remember how emerging markets typically react to downside volatility.

Why is the risk less acceptable now than it was a year ago? Primarily due to valuations, the second and more important reason to use caution with emerging market ownership right now. In early 2009, not only was the overall market historically cheap, but the emerging market category was relatively cheap. It was inexpensive against both large U.S. stocks and large developed international stocks. With value on the side of investors, the risk of emerging market ownership was greatly reduced. Today, after a 75% year in the asset class, this is no longer the case. Instead emerging market equities appear at best fairly valued versus developed international stocks. Compared to large U.S. stocks, valuations now look rich.

**Instead of a large commitment to buying emerging market equities directly, Private Wealth Advisors prefers to participate in the attractive growth in emerging markets by owning large multinational companies who derive a substantial portion of their revenues from these markets.** These companies offer a more attractive risk profile given the current stage of the economic and market recovery. Many also pay dividends, which can reduce volatility within portfolios.

McDonald's is an excellent example of this approach. The company is 65% international by sales. These companies provide breakdowns of sales by region, not country, for their international sales segment. Digging into those numbers, it is not difficult to see the impact of emerging markets' sales.

Sales for McDonald's in 2009 within the U.S. grew at 3%. The U.S. represents a mature, developed market for McDonald's. Other regions



MSCI Barra

of the world, containing both developed and emerging markets, look much different. Growth in Europe was 7% in 2009. The emerging, primarily Eastern European countries' sales numbers are included in this region. Asia, the Middle East and Africa also provided 7% sales growth for McDonald's in 2009, as did the company's "other" category, which includes Latin America. Overall, the international sales group growth was twice that of the U.S.

With the restaurant business (or other retail companies) the best way to examine international growth is to determine where new stores have been added. For McDonald's store growth was only 0.5% in the U.S. (62 new restaurants). This low store growth implies market saturation. In Europe, 157 openings occurred (half being in Russia and other emerging European nations). All of the 233 net store gains in the Asian region can be attributed to emerging countries. Over half the growth in the region came from China, where store count grew 13% in 2009. McDonald's sales increased by 6% in 2009 due to its international markets. Even with a negative currency translation hit, earning per share increased by 9%.

Coca-Cola tells a very similar story. Coke earns 75% of its revenue and 80% of its profit outside of North America. When analyzing the company's growth, we study the increase in unit case volume. For a mature business like the soft drink business, the number is low. Worldwide Coke is growing unit case volume at 2%. The remainder of revenue growth comes from pricing.

If you look strictly at the mature, developed regions alone, unit volume would be on the decline.

For the first nine months of 2009, North America was down 2% and Europe was down 1%. The emerging economies make up the difference.

The Eurasia/Africa region grew 4% for Coke. This was driven by 33% unit growth in India and 10% growth in East and Central Africa. The Pacific region was up 5%. This included a 13% jump in unit volume for China. Finally, Latin America grew by 6%. These regions clearly are filling the gap being left by the mature economies of the world.

Both McDonald's and Coke exhibit little domestic growth. Despite this issue, they are growing their overall businesses. This comes from their great global brands, which allows them to enter new markets and capitalize on the rising standard of living in many emerging market economies.

Emerging market stocks led the market off its lows in early 2009. The opportunities in these regions are abundant, and the growth profile they offer is extremely compelling. **Given what has occurred in the last year, Private Wealth Advisors is approaching this category in two ways. We maintain some exposure to emerging market stocks by owning broad indices which track those markets.** In addition to those investments, Private Wealth Advisors will hold a much larger allocation to large, multinational companies who derive a substantial piece of their business from these rapidly growing markets. These stocks allow us to tap into the growth of these markets, but lower the risk profile of portfolios due to the more stable businesses offered by multinational companies. ●

# From One Bubble to the Next

- *After a difficult 2008, credit sensitive investments rallied in 2009 to lead the fixed income market with record returns.*
- *Clear opportunities available a year ago are no longer present, making fixed income investing more difficult as investors search for yield.*
- *With the massive government deficits and the likelihood of long-term dollar weakness, hedging against higher interest rates and inflation is a prudent strategy today.*

As the stock market tumbled in the second half of 2008, many investors found very little solace in their fixed income holdings. With fear gripping the market, money poured into U.S. Treasury securities to the detriment of many other fixed income asset classes. Assets fled to what was viewed by many as the only safe, quality investment available. In the fall of 2008, liquidity tightened in the fixed income market and a further decline in prices occurred.

With the liquidity crisis wearing on numerous fixed income segments, there was one clear winner. Government bonds thrived as fear began to dictate the market moves in the last quarter of 2007 and certainly in 2008. Long maturity Treasuries returned over 27% in 2008 while many other bond asset classes were hemorrhaging. This flight to quality in the bond market left many assets battered and the Treasury market with all-time low yields.

Due to the simultaneous drop in equity prices, forced selling of non-government fixed income investments by hedge funds occurred to cover stock market losses late in 2008. This forced selling drove prices well below historic lows for several fixed income asset classes. While these events magnified portfolio losses for that year, the massive price declines set the stage for a major bond rally in 2009 for those willing to hold onto or add these depressed assets.

While numerous fixed income categories outside of Treasuries (such as some municipal and investment grade corporate bonds) posted losses in 2008, it was the credit sensitive segment (risk assets) of the bond market which offered some of the most attractive upside in 2009. High-yield bonds and floating rate bank notes both entered 2009 at prices well below fair value. For high-yield bonds, the spread over the 10-year Treasury spiked during the turmoil in 2008. By the start of 2009, spreads had reached historic highs of over 20%. Historically spreads have been about 5% above the 10-year government bond, which puts the early 2009 spread about 4 times the long-term average. While concerns over the economy kept default worries for the asset class on investors' minds, the value was difficult to ignore. Returns in 2009 have proven the apparent value which existed at the start of the year.

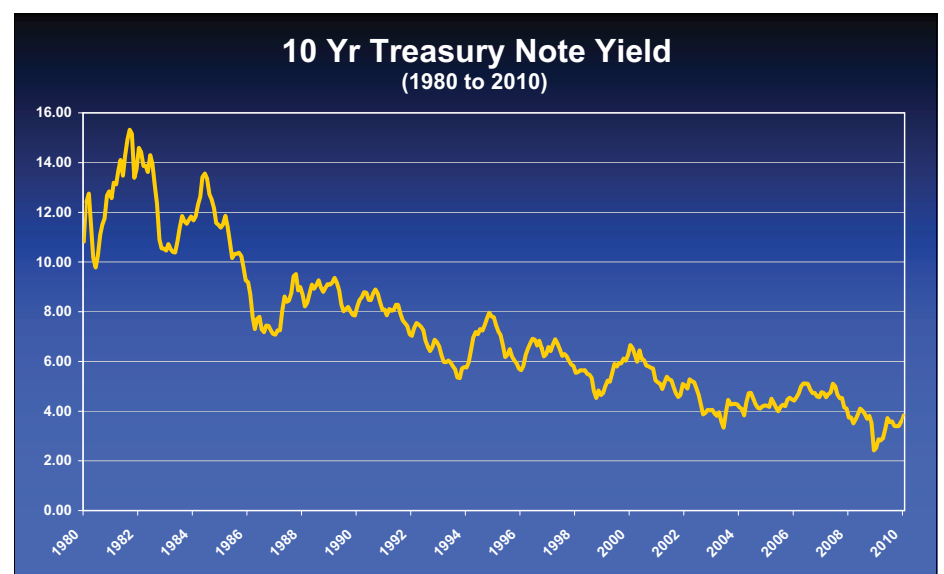
Floating-rate bank notes, although senior in the debt structure and first in line in case of default, were actually hit hardest in the fall of 2008 because the asset class was somewhat liquid. Assets were sold to raise money and loans were knocked around. Prices eventually fell to 60 cents on the dollar for the category on average. **Given the economic fears, Private Wealth Advisors (PWA) believed this category to be one of the most attractive in the fixed income market.** The senior secured feature in bank notes places them ahead of traditional bonds in cases of default, which adds some degree of safety in ownership. The

recovery potential this feature provides helps to reduce risk within a diversified bank note portfolio. Owning an asset trading nearly 40% below its fair value with the characteristics of bank notes presented a huge fixed income opportunity. Much like high-yield bonds, 2009 proved to be a boom year for bank notes. The asset class gained in excess of 41% for the year.

High-yield bonds also provided returns above the equity market in 2009, rising more than 45%. High-yields have seen spreads shrink significantly as default worries have lessened and performance has soared. Spreads have steadily declined from the spring of 2009, and now sit just 7% above the historic long-term average. Given the lingering longer term economic worries and continued high unemployment, it is not unexpected for high-yields to be trading slightly above the average.

Floating-rate bank loans followed a similar path in 2009, as their performance would indicate. As overall market sentiment improved, the selling pressure that pushed the assets lower in 2008 actually turned and upward pressure was exerted. The average price of bank notes moved from approximately 60 cents on the dollar at the start of the year to the mid 70 cents on the dollar range by the summer of 2009. As confidence in the marketplace rose, prices moved even higher, reaching nearly 90 cents on the dollar by year end 2009.

While there is still likely some upside potential in bank notes and high-yield bonds, the easiest money is now off the table for fixed income market's risk assets. As mentioned earlier, spreads have narrowed drastically. At the same time, prices have risen and looming economic concerns (while possibly pushed further into the future) have not disap-



peared. So, if those opportunities have nearly been eliminated, where can money be made within the fixed income market in 2010? It is clear it will be more difficult.

It appears as if 2009 may just be the exclamation point on what has been happening for decades in the bond market. In the early 1980s interest rates reached mid-teen levels. Ever since, rates have essentially been moving lower and today rates sit near historically low levels. A decline lasting several decades set the stage for a bond bull market as traditional bonds perform well when rates decline.

In a study published by The Leuthold Group in the summer of 2009, stock/bond return anomalies were examined. Looking back over the

## From One Bubble to the Next

Continued from page 8

past several decades, the study points out that the reward for holding equity investments (risky assets) versus the less risky 10-year Treasuries has become miniscule. Looking at annualized trailing return data, the S&P 500 Index had a negative annualized compound return in each period from one year all the way to twenty-five years. Stock performance moves into positive territory moving to the thirty through fifty year periods, but the outperformance over 10-year Treasuries is negligible.

This study shows that the notions of risk/reward have been turned on their ear. This data acts as a harsh reminder of stocks' disappointment in terms of returns. Why would investors choose to add risk to their portfolio via the stock market when a relatively low risk asset can produce very similar returns? The short answer is few would make that choice, and in 2009, few investors chose stocks over bonds. At the time of the study, the four month fund flows told a telling story. Stock mutual funds witnessed massive outflows while bond mutual funds benefited greatly, seeing massive inflows during the same period. Investors ran from the poor performing stocks and moved toward the better performing, safer bond market.

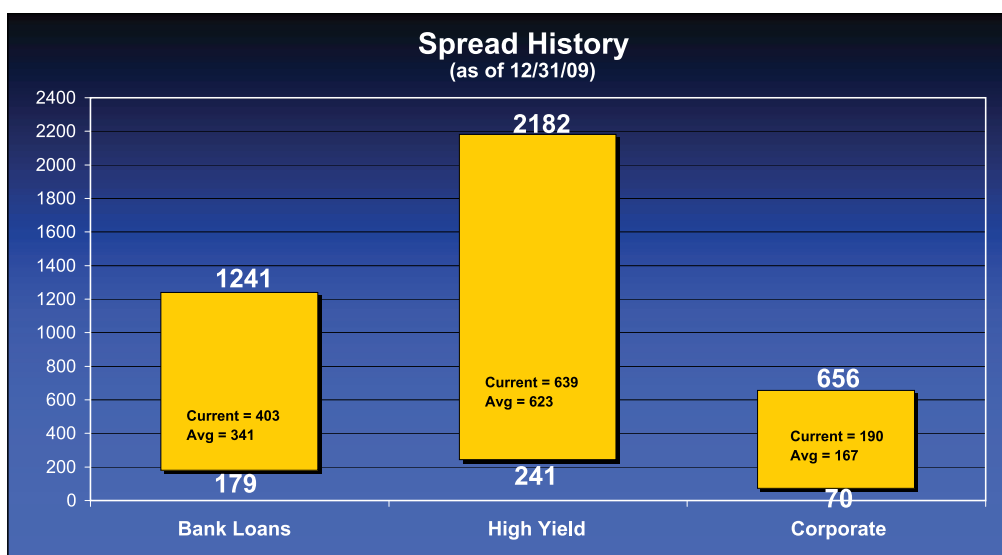
While the data presented in the study is surprising, history shows these anomalies to be short lived, and they often present opportunities. When looking from 1926 forward to the time of the study, there have been other instances where bonds have outperformed stocks over long periods of time. These instances have been rare and have not lasted long. The Leuthold Group points out that these are times to lighten exposure to Treasuries and load up on stocks. PWA believes this view can be taken a step further.

**Beyond adding to stocks coming out of a very odd and disappointing period for equities, PWA believes it is an appropriate time to take advantage of probable weakness in Treasuries in the coming years.**

The U.S. Treasury began buying agency debt in January 2009. It began buying long-term government bonds in March 2009. It has been buying mortgage backed securities since some time in 2008. All of these moves were made in an effort to bring stability to the credit markets. The government also had low interest rates in mind. These actions have created, to some extent, the illusion of global demand for U.S. Treasury securities. Instead of a strong demand from foreign nations, as some may assume when looking at Treasury purchases, foreign assets flowed away from the U.S. in 2009.

Foreign central banks carry a large stake in U.S. agency bonds. These banks want to keep the dollar from collapsing, protecting their significant investments, so they willingly play their part and aid in what looks to be a bubble-like environment for Treasury bonds. The U.S. government prints money in order to purchase agency bonds from the foreign central banks. These central banks turn around and purchase U.S. Treasury bonds with the money from the agency sales. So, in essence, the U.S. Treasury is printing the money used to buy Treasuries.

This game cannot go on forever. As of the end of 2009, the economy is beginning to recover, and there is still a strong supply of debt issuance by the government. At the same time, it has been announced that the Federal Reserve's debt purchase plan is coming to an end. These issues, coupled with already low Treasury bond returns, signals it is just a matter of time until government bond rates rise significantly – most likely by 2011.



Source: Eaton Vance

**In order to take advantage of the implications of the government's actions, PWA has initiated a short position on long-term Treasury bonds.** The stellar bond performance across many categories in 2009 has left few opportunities with significant upside going forward. Given the inflationary picture building both in the U.S. and around the world (higher food, gas and commodity prices), an extremely low interest rate environment allowing increased monetary supply and a devalued dollar, there is a high likelihood of higher interest rates in the next twelve to twenty-four months. And the rise in rates could be substantial.

**PWA has selected the ProShares Ultra Short 20+ Year Treasury ETF (TBT) as the primary investment to execute a short-term strategy as long-term rates approached 4%.** This investment seeks to provide twice the inverse of the daily performance of the Lehman Brothers 20+ Year U.S. Treasury index. The position was established while long-term interest rates were between 4% and 4.25%. A rise in the long bond to 5.5% should mean a 30%-35% increase. For an index seeking to provide twice the exposure, it is not difficult to see how this strategy would benefit a fixed income portfolio. It is important to understand a leveraged investment, such as TBT, has the potential to erode returns over the long-term in cases where market volatility is substantial. As a longer-term strategy, we recommend the Proshares Short 20+ Treasury ETF (TBF) which provides only one time the inverse of daily performance of the Lehman Brothers 20+ Year U.S. Treasury index.

**While there is obviously downside to this strategy, PWA believes the downside is limited given the current level of interest rates.** Plus, any significant decline in the yield of long-term Treasuries would be short lived given the actions of the Treasury and the high likelihood of rising inflation in the future.

The bubble created by the Treasury while managing the credit crisis has created an opportunity for investors to capitalize in their portfolios while adding protection against rising rates to their holdings through this hedge. In addition to the hedge, we believe holding cash and maintaining positions in credit sensitive bonds (such as floating rate bank notes which still offer upside in terms of total return near 10%) is prudent. The bond rally in 2009 erased many large opportunities in the fixed-income market, but it is still possible to add value in the bond market and avoid the Treasury trap.

The spending occurring at the government level will, most likely, lead to higher inflation in the coming years. With higher inflation comes higher interest rates. Rising rates pose a threat to holders of intermediate and long-term Treasuries. **Given the meager yields offered by government securities, it is prudent to look to other fixed income asset classes that offer superior opportunities.**

## ● *Fixed Income / Equity*

The Private Wealth Advisor is published on a quarterly basis. Changes are made to our portfolios throughout the year (especially considering the current volatility of the market), but not discussed in print until the next issue is released. Managing a portfolio purely based on changes printed quarterly will not accurately reflect the tactical decisions made within Private Wealth Advisors' portfolios. Additionally, measuring the success of these changes accurately is problematic given the regulatory environment of our industry. This information is not intended to be used in trading or managing your investments.

Allocation of your investment assets between equity and fixed income is largely dependent on three factors: cash flow needs, risk tolerance levels and current market forces. While the first two are client specific and also the primary drivers for overall allocation, market forces should not be ignored. The S&P 500 Index normalized price/earnings ratio stood near 17 at year end. This level put stocks close to the long-term historical average. Historically, buying stocks at these general levels has resulted in returns near the long-term average. Considering the low yield environment in the Treasury market, equities are appearing relatively attractive.

## ● *Equity Allocation*

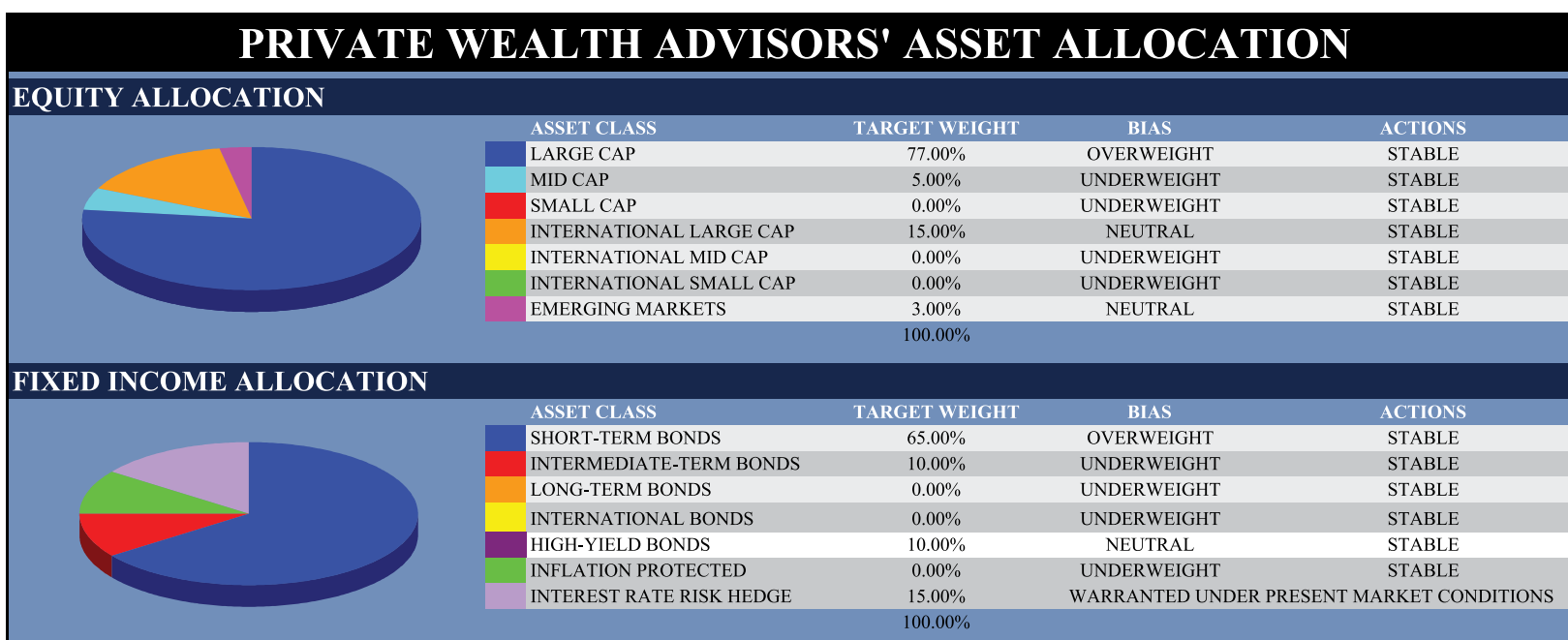
Our bias toward large companies versus small companies continues, especially with domestic stocks. Economic concerns still loom, and we are much more comfortable holding large, multinational companies with strong balance sheets going forward. While small cap U.S. stocks have struggled slightly on a relative basis, their valuations remain lofty. Large company growth stocks showed strength versus value stocks in 2009, largely due to the performance of the technology sector. Our shift toward the technology sector in late 2008 aided returns greatly in 2009. While our bias toward the growth side of the market remains heading into 2010, it will only be slight. Our general outlook is for high single to low double digit returns for U.S. stocks in 2010. Therefore, we

have begun to shift our focus to less cyclical, dividend oriented companies. The above market dividend for many of these companies should aid portfolios in a low growth environment, and their defensive nature should allow for superior relative performance if the market pulls back. Many of these stocks can be found in the following sectors: consumer staples, health care, telecommunication and utilities. A combination of these sectors, plus technology stocks, makes up our overweight positions heading into 2010. While growth prospects are still high in the developing markets, their 70% plus returns in 2009 make us somewhat cautious. We will maintain our exposure to both developed and emerging market stocks, but will not increase exposure at these levels.

## ● *Fixed Income Allocation*

Short-term rates remain near 0%, and it is difficult to find an attractive yield amongst the traditionally safe investments. Treasuries are particularly unattractive given their low yield and susceptibility to interest rate risk. We continue to hold floating rate bank loans as a primary short-term fixed income vehicle. This asset class has recovered greatly from the December 2008 lows and still offers an upside in terms of price appreciation. Plus, their floating rate component takes interest rate risk out of the equation for the most part. High-yields also remain somewhat attractive to begin 2010. We established a substantial long-term interest rate hedge position in the fall of 2009. Given the major deficits

facing the U.S. government, it is our belief rising interest rates and inflation are inevitable. This position will benefit fixed income portfolios as long-term interest rates move higher. Our preferred solution to the low rate environment is to commit a portion of a portfolio to real estate properties or limited partnerships owning a variety of properties. Real estate generates a steady income stream, often higher than today's low bond yields. In addition, properties have a much higher likelihood of appreciating over time versus other fixed income investments, thus adding to a portfolio's total return.



# WHAT WE DO

## ● **Tactical Asset Allocation Portfolio Management**

Our proprietary modeling strategy is used to determine opportunities in various asset categories globally. Asset allocation decisions are formulated by our Investment Committee using a long term relative valuation matrix.

*The strategy has two primary goals:*

- Reduction of risk by minimizing exposure to expensive segments of the market.
- Improved portfolio returns by investing in undervalued segments of the market, using both passive and active management to execute these strategies.



Front Row (L-R): John Schneider, CFP® (President), Joseph Scarpo, CPA, PFS (CEO), Stuart Miller, CFP® (Chairman)  
Back Row (L-R): Daniel McCurry, CFP®, Scott Miller, CFP®, Jody Werner, Michael Passalacqua, CFP®, Michelle Bender, CFP®, Keith Biskup, Arthur McAuley

## ● **Individual Managed Stock Portfolios**

The S&P 500 Index is used as the benchmark for investing in individual stocks for our clients. We rank sectors top to bottom using technical indicators and fundamental analysis.

Once our Investment Committee chooses the sector allocation for the portfolios, our team of research analysts populate each sector to our desired weightings using individual stocks and sector/industry indexes.

## ● **Individual Bond Portfolios**

Private Wealth Advisors uses all fixed income opportunities when designing our bond portfolios for clients. We balance interest rate risk and credit (default risk) for our clients by using all available fixed income instruments. An example portfolio might consist of individual municipals and corporate bonds, closed end mutual funds, index funds and actively managed open end mutual funds.

## ● **Real Estate Portfolio**

Regional real estate is acquired with the goal of providing high current income, along with tax benefits for our clients. The professionals of PWA Real Estate, an affiliate company, seek opportunities in our region to build diversified property portfolios for our clients.

## ● **Alternative Investments**

In addition to real estate, Private Wealth Advisors employs a variety of alternative investment vehicles appropriate for a client's risk tolerance, investment goals and investment experience, e.g., oil and gas limited partnerships and long/short portfolios. Our goal is to provide competitive returns while managing overall portfolio risk.

## ● **Coordinated Financial Advice**

Our principals have a combined 70 years of experience in counseling clients in virtually all areas of personal finance including:

- Estate and Trust Planning
- Retirement/Elder Care Planning
- Income Tax Planning
- Business Succession Planning
- Employee Benefit Planning
- Philanthropic Planning

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