
PORTFOLIO COMMENTARY

FROM THE ALDER FINANCIAL MANAGEMENT TEAM

ISSUED APRIL, 2010

A Little More Breathing Room

U.S. stock prices extended their rally during the first quarter, largely driven by the growing conviction that the U.S. economy is on the mend despite weak spots such as in housing.

The Dow Jones Industrial Average gained 4.1% or 428.58 points during the first quarter, to 10,856.63. That marked the Dow's fourth consecutive quarterly gain and the best first-quarter performance since 1999. The broader Standard & Poor's 500-stock index rose 4.9% to 1,169.43, but remains 25% below its all-time high posted in October 2007.

As has been the case since stocks hit their lows in March of 2009, the best-performing stocks have tended to be the most volatile and generally lower-quality names. The Russell 2000 index of small-company stocks posted the largest gain among the big benchmarks with an 8.5% rise. Financial stocks, too, rallied despite the likelihood of stepped-up regulation and lower future profits. The Financial Select SPDR gained nearly 11% for the quarter.

The trends that had helped share prices stage a remarkable recovery in 2009 continued to provide a favorable backdrop for U.S. stocks. The three pillars of support for the market have been much improved earnings over last year, record low interest rates and a continued weak dollar.

While we believe that these positive trends will remain in place for some time, stocks will probably face their biggest challenge of the year in the second quarter. The Fed appears to be inching forward with its plans to end, and ultimately reverse, its unprecedented easing of credit. More problematic for the market could be the Fed's removal of credit-market supports. Should this fail to go smoothly stocks could be in for another rough patch. Either way, we believe this will only add to this summer's volatility and not impact the final performance for the year.

In general, we remain optimistic about the stock market for this year and probably 2011. We firmly believe that interest rates and inflation are headed higher due to the massive amount of borrowing by the federal government. This will be the real headwind for the stock market but, of course, no one really knows when that will hit. In the meantime, we plan on staying fully invested in the stock market to benefit from the improving economy. When we do start to see rates moving higher, we'll evaluate the economic landscape and adjust our allocation strategy accordingly.

While our client portfolios benefited greatly from the improved equity performance, the real bright spots in the portfolios have been the distressed mortgage-backed bonds purchased last year. We have now owned these for the better part of a year and are able to compare the results to our expectation when we first bought these bonds. They are proving to be an outstanding success and largely responsible for the majority of our portfolios being within 10% of their 2007 highs. This compared to the stock market still being off 25% below its October 2007 level.

Looking forward, we see challenges in finding attractive fixed income yields. As the economic risks subside, so too are the risk premiums. Bond prices are finding their normal levels now that the wave of last year's forced selling has passed. Couple this with impending rising rates, and you're not left with many attractive choices.

Fortunately, most of our fixed income allocations have been placed by now. What we are largely left with is the reinvestment of cash flows coming off our existing securities. We've added several closed-end funds and fixed income ETF's to fill this need. Our thinking is that we'll see better investment opportunities in this area towards the end of 2011.

In the meantime, we'll continue our focus on the equity side of the portfolios. We still believe there are additional gains to be had from here. We believe the 33% gain from here that is necessary to get back to 2007 levels is doable over the next two years. If we see those types of returns on top of the mortgage-back bond returns we already have locked in, most of our portfolios should reach all-time highs.

Investing is rarely easy. In times of extreme volatility, there are always winners and losers. The losers this time around were those who borrowed heavily and then were forced to sell to repay those loans. Ultimately, the winners will be those with plenty of cash that can be on the other side of that trade. The saying that cash is king has never been truer.