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# PORTFOLIO COMMENTARY

FROM THE ALDER FINANCIAL MANAGEMENT TEAM

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## The Long Grind to a Full Recovery

Financial markets of just about every type pushed higher in 2010, marking a second year of recovery from the financial crisis. As seen in the following table, the small and mid cap sectors performed especially well. In fact, these indices are currently trading at their 2007 levels, while most of the other large cap indices are still down 18% from their 2007 highs.

As was the case in 2009, investors can thank continued, unprecedented efforts by governments and central banks around the globe to keep their economies and financial markets afloat for those good returns.

The most direct support came as central banks propped up government bond markets in the

U.S. and Europe. That then indirectly lifted corporate bond and stock markets. By its very nature, the government's bond market intervention (quantitative easing) is designed to inflate prices of financial assets. Through massive purchases of Treasuries, the Fed is keeping bond yields low and displacing other investors. This forces them to buy riskier investments, such as stocks or corporate debt, an effect that eventually filters through to the economy.

Sooner or later there will be a price to pay for all these efforts. But for the time being, investors are being rewarded for not fighting the Fed. Our belief is that it's best to be bullish until the bill comes and that it's a mistake to stand in front of all that stimulus.

We recognize that at some point central banks will have to reverse their stimulative strategies as their economies and markets can stand on their own. As 2011 begins, the talk of exit strategies is concentrated only on the emerging markets, where some central banks, such as those in China and South Korea, are starting to ramp up tightening efforts. Among the world's biggest developed economies—the U.S., Japan and much of Europe—the consensus is that support efforts will continue. That should be good news for riskier investments, such as stocks, high-yield bonds and commodities. For this reason, we're optimistic that 2011 will be another good year.

All of this stimulus will eventually come at a cost in the form of higher inflation and exploding budget deficits. In fact, we're already seeing prices of economically sensitive commodities rise, but it's impossible to know when inflationary pressures will become systemic enough to warrant a change in Fed policy.

Domestic			
Dow Jones Industrial Average	11,577.51	+1,029	+9.8%
S&P 500	1,257.64	+131	+11.6%
S&P Mid Cap 400	907.25	+248	+37.6%
S&P Small Cap 600	415.73	+78	+23.2%
International			
Dow Jones Global ex-U.S.	221.46	+21	+10.7%

Whenever this time comes, bonds will be the first to feel the impact of higher rates. This has led many pundits to advise investors to stay away from bonds. On the surface this is true. In practice the decision is much harder. This is because short-term rates are near zero and sitting in cash while waiting for rates to go higher only guarantees a loss in real terms. We think the tradeoff between safety and return is too high if rates take longer than a year to go materially higher. Thus, we've focused on finding very short-term bonds, bonds in distressed markets and high-yield debt that is more correlated to growth than interest rates.

Our strategy for dealing with higher rates is to make sure that our clients' cash flow is high enough to be able to reinvest at the higher rates. In that sense, higher rates can be a benefit and not something to be afraid of. For years we've been stuck in an extremely low yield environment and investors have struggled for income. For them, higher rates would be a welcomed change. It would also signal a much improved economic outlook and we could all do with that.