

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

Entering the earnings reporting season for last year's fourth quarter, analysts have firmed up their expectations. For a few months during the late summer and early fall, profit forecasts were being trimmed a bit. The latest improvement comes on the heels of a generally brightening overall economic picture. Specifically, employment indicators are signaling that the corner may have been turned for the job market. First time filings for state unemployment insurance have dropped fairly sharply recently. Employment agencies had been hinting all along that prospects were improving. Much of the strength appears to be associated with manufacturing and exports. Service industries, in contrast to their normal resiliency, are lagging expectations. Of course, the construction trades are the farthest behind. But even there, increased sales of pickup trucks seem to be suggesting the worst could be over. So it should not be too big a surprise that analysts have also started to ratchet up their expectations for sales and revenues. No doubt with commodity prices so strong, part of the increase in the top line reflects a bit of industrial inflation. But there certainly is reason to expect that unit volumes are also picking up, particularly noting the export improvements. For investors an important juncture might appear to be ahead: while profits have expanded sharply, almost all of the gains have been attributed to hard-nosed cost containment. Now, with unit sales also expanding, analysts will have to be more careful about the way profit margins are generated. As labor is added to the equation, productivity will have to be strong enough, or margins could suffer. Considering that these margins are at historic levels, some decline would be natural. And, of course, the total dollars of profit will still be rising, even if a bigger share goes to wages. There is a tradeoff here. Higher employment means greater income and confidence to buy the products and services of American business. Our thought is that we can relax a bit and enjoy the break in the clouds hanging over the economy. Down the road, there will be plenty of time to worry about the mix of national income.

Our Practical Value model is indicating that equities are no longer under-valued. However, given the rapidly

improving economic outlook, profit growth could forestall the arrival of such over-valuation. Corporate insiders seem to agree. After a period of some selling, insiders have begun to move back to the buy side. Managements have already raised dividends and increased share buybacks. Surveys of investor opinions have moved toward more agreement with a bullish outlook. Options traders are also now increasing their positive bets by buying increased amounts of call options. In all, these measures of Practical Value are beginning to raise a market challenge. However, a mere rise in general bullishness by itself is rarely enough to quickly reach a dangerous juncture. Rather, it is important to be alert to the time when attitudes are at an extreme and begin to change. That is, it is hard to know when an increasingly crowded room is actually dangerous, but at some point it's important to start watching the exits. When the crowd begins to thin, that is often the time when reversals are more likely. The current picture looks more like markets which, having digested a lot of time and conflicting information (2010 was a good example), receive an overriding clarification. The improving economic climate could well be that clarifier. Some examples of those markets are 1978, 1984, 1995 and 2004. The ensuing moves were characterized by lower volatility and reasonably steady progress: in short, less drama.

Our Economic Liquidity model still shows plenty of liquidity, directly attributable to the "emergency" measures of the Federal Reserve. Less than two months have passed since the Fed embarked on its second round of direct liquidity injection into the financial markets (QE2). Attitudes are less clear however. Some investors are apprehensive about the Fed's ability to both expand the economy and keep inflation at bay. Thus, interest rates have risen since the Fed's announcement in August redoubling its easy monetary policy. The easing just adds liquidity to a system that has huge amounts of corporate cash on the sidelines and evidence that even consumers have made major repairs to their balance sheets. As in the case of valuation, it is important to be alert to the potential negative elements in the environment. But our research suggests the underlying factors are still supportive.

Our Momentum model is bullish. The breadth of the market advance has been pretty good. Stock market leadership is drifting toward smaller capitalization companies. Investors are being rewarded for taking a little more risk. Cyclical stocks have consistently outperformed more defensive companies. These are all solid signs. However, low trading volume continues to be a major challenge for the bulls. Given the noticeably improved economic background, the market will have to extend and expand today's risk-taking trends. Failure to do so would likely do damage to our model.

Our Bond model is now entering the negative zone. Even with massive monetary easing, interest rates on Treasuries have moved sharply higher. While commodity prices have shot higher, overall inflation rates remain tame. Corporate debt has generally done much better than Treasuries and the total picture tends to suggest the "Bond Vigilantes" are guessing the improving economy will force the Fed to ease off on the accelerator. One new factor on the horizon is growing political scrutiny of the Fed. Regardless of the merit or motives of that scrutiny, investors likely will note that uncertainty is rising.

EQUITY UPDATE:

As the US economy improved in December, the stock market did not disappoint. Although trading volumes were low, investors got their seasonal strength, or "Santa Claus rally". The S&P 500 was up 6.5% for the month, and 12.8% for the year. The Dow Jones Industrial Average was up 5.2% for the month, and 11.0% for the year, and the NASDAQ Composite was up 4.7% for the month, and 16.9% for the year.

For the month, there was a continuation of the market themes that worked during the entire year. Correlations among stocks continued to decline, resulting in good opportunities for stock pickers in December. Small capitalization stocks outperformed large capitalization ones. "Growth" outperformed "value".

There was also a continued tilt towards cyclical investments for the month, quarter, and year-to-date. The best sectors in 2010 were consumer discretionary, industrials and materials. The worst sectors were utilities and healthcare.

The strongest S&P 500 group in December was financials, up 10.6%, and about the same, or 10.8%, for 2010. The catalysts for the short-term performance in this sector were three-fold. First, the economy improved, which led to a steepening of the yield curve. Viewed another way, interest rates rose more on longer-dated fixed income securities than shorter-dated ones. This phenomenon leads to higher loan margins for banks. Second, investors are anticipating that banks will reinstate dividends that were discontinued or lowered during the financial crisis. Third, there was talk of Bank of America settling issues related to the securitization of bad loans through Countrywide Credit, which Bank of America bought. We continue to be concerned about the unknown liabilities associated with mortgage and

foreclosure issues over a longer time frame, and will watch this sector carefully.

The materials sector was second, up 10.1% for the month, and 19.9% for the year. The group benefitted from an improvement in the US economy, and insatiable demand from emerging markets. Many industrial commodities, like copper, had a strong December and closed the year with prices at new 52-week highs. The materials rally was broad-based among sub-sectors. We are overweight the group in both the US and International components of our portfolios.

Asset Allocation Highlights	
Asset Class	Position
Domestic Equities	Overweight
International Equities	Overweight
Bonds	Underweight
Cash Equivalents	Neutral
Sector Over/Underweights	
Sector	Position
Information Technology	Overweight
Industrials	Overweight
Consumer Discretionary	Overweight
Materials	Overweight
Energy	Neutral
Utilities	Neutral
Telecom Services	Neutral
Financials	Underweight
Health Care	Underweight
Consumer Staples	Underweight

Data as of 12/31/10

This commentary contains forward-looking statements about various economic trends and strategies. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. For a full set of disclosures see the back page of this commentary.

The third best sector in December was energy, which was up 8.9% for the month, 20.8% for the quarter, and 17.8% for the year. Energy was the strongest sector in the fourth quarter. It benefitted from the same cyclical trends as the materials sector: an improving US economy, and strong demand in emerging markets. We are overweight here.

Telecom services were fourth, up 7.5% in December, and 12.3% for the year. These numbers do not reflect the total return of this sector as a result of the high average annual dividend yield of over 5.0%. The group benefitted from expectations that increased usage of tablet computers will increase the demand for telecom services. Verizon Wireless was up 11.9% in December on strong Droid smart phone momentum, introduction of the iPad and the Samsung Tablet, and the anticipated introduction of a Verizon iPhone in the first or second quarter.

Industrials were in fifth place for December, up 7.5% for the month, and it was the second-best sector for the year, up 23.9%. Ryder Systems was the number one stock in the group this month, up 22.1%. It is seeing rising demand across all its products, especially full-service leasing of trucks and fleet maintenance contracts. We are overweight the sector. We own the SPDR, Industrial Select ETF (ticker XLI), which was up 25.5 % for the year.

The sixth-best group was information technology, up 5.2% for the month and 9.1% for the year. This sector has been a stock picker's heaven all year. Growth companies with new products and technologies, especially in cloud computing and mobile technologies, have generally outperformed other technology stocks. The best stock for the year, F5 Networks, which is a play on cloud computing, was up 145% for the year. Micron Technology, which makes memory chips, was the worst performing stock in the sector in 2010, down 24%. We own the Ishares, North American Technology-Multimedia Networking ETF (ticker IGN), which has exposure to both cloud computing and mobile technology. This ETF was up 24.2% for the year. We are overweight the sector.

Healthcare came in seventh, up 4.3% for the month. However, it was the worst performing sector for the year,

up .7%. In December, medical devices and bio-tech companies generally outperformed the broader based healthcare index. These stocks have some growth characteristics, which benefitted them in the quarter. However, the group's defensive characteristics did not prove a benefit for most of the year. Coupled with concerns about continuing change to healthcare reform legislation, the sector was an overall underperformer. We are underweight it, but will continue to look for higher growth sub-sectors within it.

Consumer Discretionary was the eighth sector in December, up 4.0%, but was the number one sector in 2010, up 25.7%. Five of the top ten best performing stocks in this sector in December were housing related: Lennar Corp., Whirlpool, Pultegroup Inc., DR Horton and Home Depot. We bought the SPDR, Homebuilders ETF (ticker XHB), which owns all of these, and other companies, in early December. In addition, the fourth quarter was fabulous for retailers. As consumers spent less on their homes, they spent more shopping on-line and at the malls this holiday season. We are overweight this sector.

In ninth place was consumer staples, which was up 3.8% for the month, 5.3% for the quarter, and 10.7% for the year. As the economy has improved and investors have taken on more risk, this rather stable group of companies has underperformed the S&P 500. Additionally, some companies are experiencing margin pressure due to rising input costs, such as food or raw materials. We are underweight this sector.

Utilities came in last for the month, up 2.7%, and up .8% for the year. However, these numbers do not reflect the high average annual dividend yield of over 4.4% for the sector. Yields have been rising, which would make comparable corporate bonds more attractive than they have been relative to utility stocks. This small sector of the S&P 500 generally does not do as well in an improving economy, when investors are willing to take on more risk.

As we ponder the data, and watch this market, we will approach the task of portfolio management as we always do: with a thoughtful implementation that is well diversified and pays close attention to the risks we see in the marketplace.

FIXED INCOME UPDATE:

At a time when the developing and the European economies are marginally slowing, the U.S. economy is clearly accelerating. As the world's largest economy, and its biggest exporter, this growth can act as a locomotive for everyone. What needs to happen now is for domestic business to reach a self-sustaining rate of expansion. The process for that is fairly straightforward: employment has to increase by enough to start to make a dent in the numbers of the unemployed. As a rough guide, that translates into a growth rate of real GDP of more than 3%.

The consensus forecast for this year's GDP growth is about 2.6%, which is actually a little less than for 2010. Thus, most economists are not yet expecting the economy to reach breakaway speed. In contrast, our research models are picking up a broadening in the elements of expansion. The number of states experiencing growth far exceeds those which are moving sideways. Surveys of corporate managers are accelerating on a broad front. Stocks that are more cyclical are outperforming defensive companies. In the credit markets, the premium required for taking on risk has narrowed. Both bond and stock investors are keenly aware of the stakes in the economic outlook. To the extent investors believe the growth rate of the economy has a connection to the inflation rate, then, typically, bond investors are pretty happy with bad economic news. Those stock investors who condition their valuations based on competition from bond interest rates are okay with low rates, but maybe not as happy with slow economies and likely subdued profit conditions.

Even though broad measures of inflation are well contained, interest rates on long-term Treasuries have jumped dramatically over the last four or five months. Not only has reported inflation been fairly low, but surveys of expectations of inflation are likewise pretty tame. And the inferences that can be gathered from how the bond market is pricing various maturities also confirm the notion that inflation is not an imminent danger. The biggest argument

against inflation is the huge degree of unutilized labor and factory capacity.

There is an argument that can be made, therefore, that the backup in long-term Treasury rates is overdone. But there is another argument that, even with low inflation, rates can rise. First, interest rates are still generally at historic low levels. More important, the Federal Reserve has described its short-term interest rates as being at "emergency" levels. This begs the question of whether or when the emergency abates. Very likely the Fed would be forced to admit that, when the economy approaches breakaway speed, the emergency is on the way to ending, if not over.

Instead of being at about 25-basis points, the Fed funds rate would "normally" be somewhere near the inflation rate, or at least 150-basis points higher than currently. That kind of increase would put upward pressure on long-term rates. The argument for waiting as long as possible before moving back to normal is the still fragile state of mortgages. And higher long rates would be a clear negative. But perhaps balancing that out would be a better labor market, which has always been the key prop to housing and finances.

Equity investors might just accept the challenge of higher rates if, and it is an enormous if, the markets are reflecting an overall healthier environment. Unlike last year when the big questions would hang on for most of the year, the anecdotal evidence this time around is building toward an early resolution.

Contact Us:
Avatar Associates
575 Lexington Avenue/8th Floor
New York, New York 10022
Tel: 212-624-1900 Toll Free: 800-447-9226
Fax: 212-624-1934
www.avatar-associates.com

Investment Philosophy:

- 1) Avatar believes that a portfolio's stock/bond/cash mix has the greatest impact on risk and performance.
- 2) Avatar employs quantitative, top-down, macro-economic models in its decision-making process.
- 3) Avatar uses a disciplined and flexible asset allocation approach designed to generate solid returns by reducing the perils of volatility.
- 4) Avatar implements its quantitative discipline according to the clients' needs, utilizing futures, ETFs, stocks, bonds, and mutual funds.

Avatar Associates specializes in tactical asset allocation and manages approximately \$962 million in assets. Clients include institutions, wrap brokerage sponsors, financial planners, and private clients. Product offerings include overlay, sector rotation, fixed-income, defensive equity and core equity. Avatar Associates employs a quantitative, top-down, macro-economic model, refined qualitatively by a seasoned research and portfolio management team. For more information about Avatar Associates, please visit www.avatar-associates.com.

All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice. Past performance is not a guarantee of future results. This commentary contains forward-looking statements about various economic trends and strategies. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should always be made based on the investor's specific financial needs and objectives, goals, time horizon, and risk tolerance. There are no guarantees associated with any forecast; the opinions stated here are subject to change at any time and are the opinion of Avatar Associates.