



Small Riders May Win This Race

Key Themes from Mid August, 2010

Summary

- A yield trap may be building. Beware of overpaying for income!
- Small emerging markets are strong – relative to Europe and the United States, they are unburdened by debt and regulatory gridlock, and not so worried about the withdrawal of government stimulus. MSCI EM Index in an ETF is one way to catch the trend – large cap exporters in the developed markets may be the cheaper way to invest in the growth trend.
- Returns of asset classes and managers are bunched tightly together; very little leadership... yet.

La Tour de Equities

I tend to shun sports analogies ... unless they involve some under-appreciated pastime or are particularly appropriate.

Bicycle racing feels appropriate this year: the 2010 financial markets remind me of the Tour de France. Dozens of traditional and alternative asset class returns are packed together in a massive peloton. Returns, like peloton riders, are separated by shades of difference. Leads are given up and taken. And spectators await a breakaway to define both the race and the winner.

This is a critical point in the race, because history has shown that this is the stage in past economic "tours" where recovering bear markets reveal themselves as sustainable ... or not. The markets of 1935 and 1975 were not. But more often than not, over history, markets and economies have found higher ground from here.

The income generators are the leaders of the 2010 race. Perhaps the market is telling us that as capital gains are far from certain, investors are more and more craving cash flow – real yield in the form of coupons and dividends. But the real challengers now, and perhaps the hope for growth in a debt-handicapped world, come from countries that would be heading into the economic abyss if this really were 1935 or 1975.

Leaders of the Race to Date

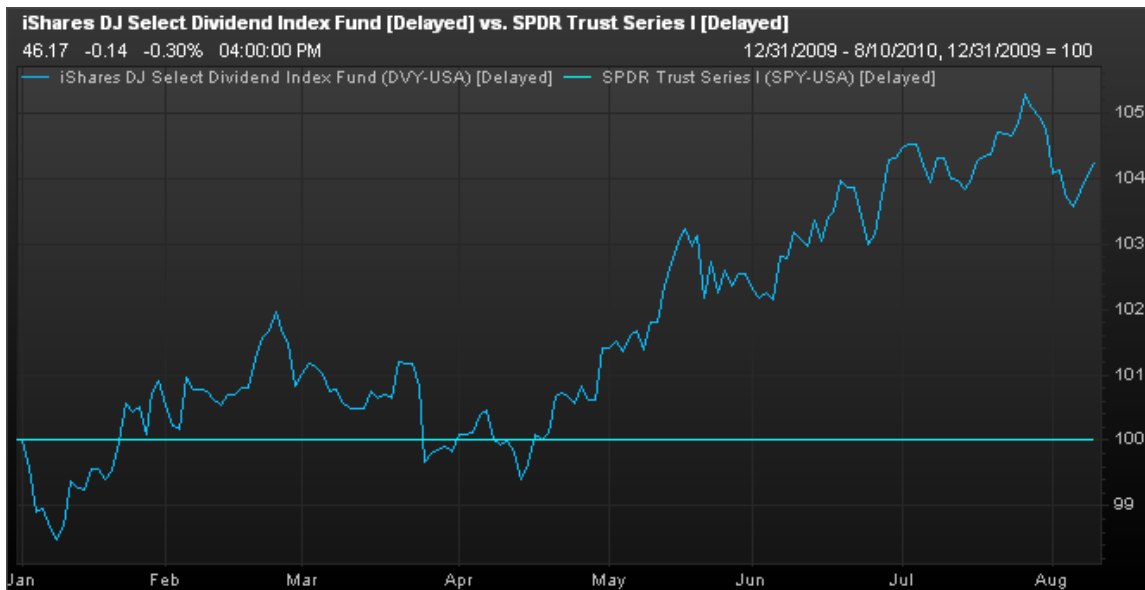
30-Year US Treasury Bonds: "Tour leader" for 2010 so far has surprised the field and shown few signs of flagging. However, a recent headwind is blowing from the east: the US dollar has weakened as foreign investors withdraw support. The Euro has snapped back to some degree as investors believe the currency will survive and Germany, in spite of populist grumbles about supporting weak economies, is benefitting nicely from currency weakness. The yen and Yuan strength also shows the vulnerability of the long treasury position.

Income Generating Strategies, including:

Real estate (REITs) domestic and global: This leadership isn't surprising, considering the deep REITs sell-off of the past 3 years. The recovery is driven by not only the gradual emergence of real net-asset property values, but also by desire for yield. In spite of strong relative performance, our portfolios in the small cap value side continue to maintain substantial underweight to REITs.

High dividend paying equities: Dividend payouts are rising ... and so is capital appreciation of companies with higher yields. Preferred stocks and convertible returns have also been strong.

Emerging Markets Debt/High Yield/Corporate Debt: Absolute yields are low and spreads have narrowed, making the JP Morgan EMBI+ Index, Barclays High Yield Index, and Barclays BBB the top return-producers and have humbled equity returns. IBM's recent corporate bond issue set new lows for yield.



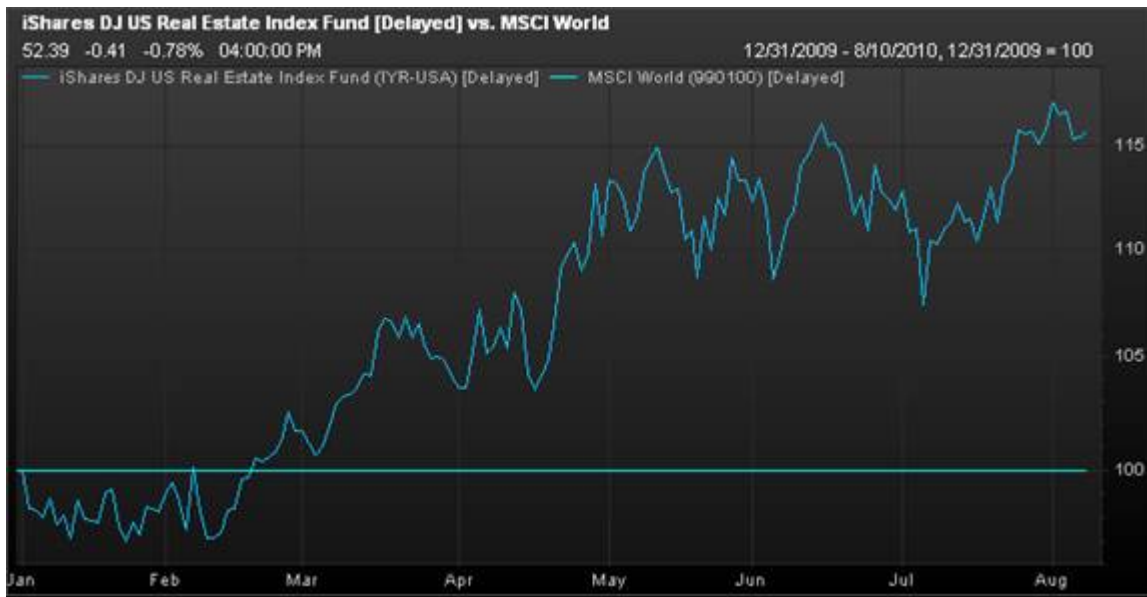
Source: Factset

As the global equity markets turned down in April, high-yield stocks surged ahead. This is the performance of the iShares DJ Select Dividend Index ETF relative to the S&P 500®.



Source: Factset

Investors have noticed that quality of once chronically mismanaged sovereign credits like Turkey equals and surpasses the credit quality of developed markets like Italy, Spain and Portugal. Emerging Markets bonds have posted very strong relative performance this year.



Source: Factset

REITs continue to climb the wall of worry in real estate and rank near the top of returns among global equity sectors.

The “income theme” leads the pack, but is beginning to look tired. History shows higher-yielding investments to be very cyclical and capable of reversing abruptly. If nothing else, be very wary of timing right now, even for clients who need the cash flow.

Key Breakaway 2010 – New Emerging Markets

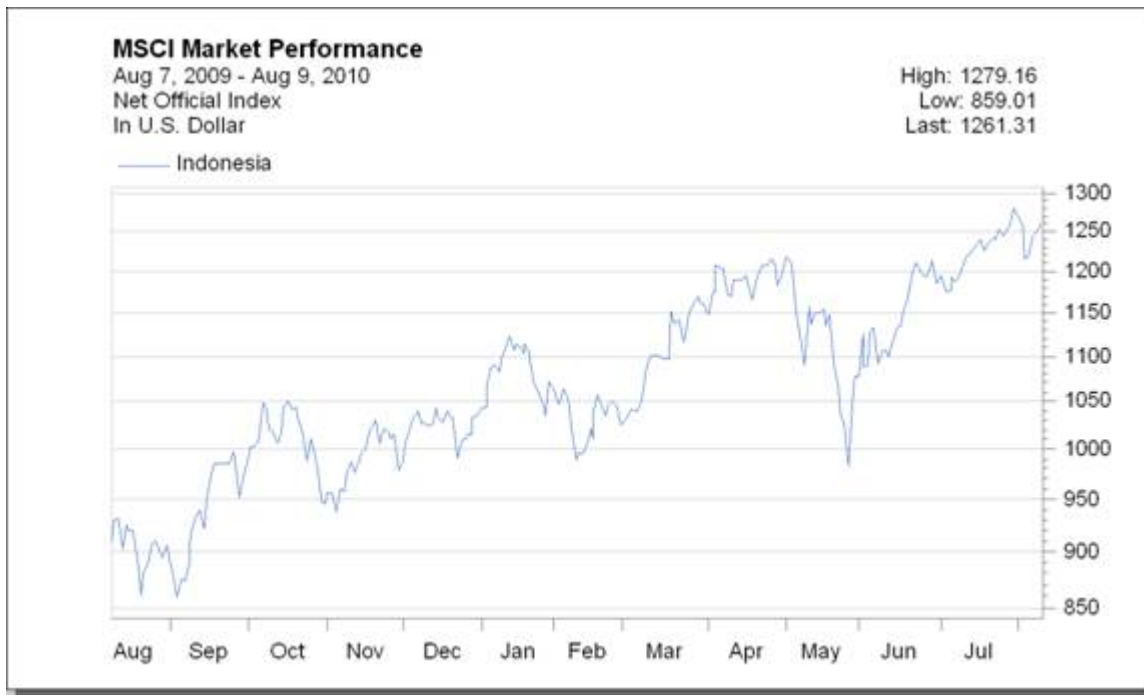
Leadership in Emerging Markets has shifted away from the BRICs (Brazil, Russia, India, and China) and into newly stabilizing economies. These markets bear watching – not simply because they are practically the only producers of double-digit returns year-to-date, but because they may be establishing new and sustainable emerging economic leadership. The stories of economic growth in Indonesia and Turkey in 2010 could have been drafted by Thomas Freidman or Fareed Zakaria. These country markets are small in capitalization, but their importance may be growing rapidly to a size that may begin to approach the size of population and natural resource advantages.

Simply stated, relative to Europe and the United States, these small markets are unburdened by debt and regulatory gridlock and not so worried about the withdrawal of government stimulus. Growth in GDP expectations seems to be increasingly independent of the mood swings found in the west’s expectations.

New Leaders:

Indonesia, Malaysia, Chile, Turkey

Note that while these four countries together contain approximately 409 million people (39% more than the United States), the US market capitalization is about 44 times larger than all four markets combined. These are still small and illiquid markets filled with risks of all flavors.



Source: Factset

The Indonesian market is making new all time highs. While a lot of foreign "hot" money is helping move it, there really seems to be new political stability coupled with a desire to grow. Note, however, that May & June demonstrated the downside potential of corrections on such "hot" markets.

We are invested in the Emerging Markets, but are very cautious. The broad MSCI EM Index is burdened both by high expectations and above-average valuations.

Chart 1: Bottom up equity FYI P/E by index

INDEX	Median FY1 P/E							
	Current 7/28/2010	13 Year History Average	Current/ LT Average		Current 7/28/2010	6/29/2010	12/31/2009	9/30/2008
Russell 1000	15.0	18.1	83%		15.0	14.5	17.2	14.1
Russell 1000 Growth	15.8	20.8	76%		15.8	15.0	17.7	15.1
Russell 1000 Value	14.3	16.2	88%		14.3	13.5	16.3	13.2
Russell Mid Cap	15.4	17.8	87%		15.4	14.8	17.5	14.1
Russell Mid Cap Growth	16.3	20.4	80%		16.3	15.6	18.2	15.2
Russell Mid Cap Value	14.8	15.9	93%		14.8	13.9	16.5	13.2
Russell 2000	17.2	18.2	95%		17.2	16.3	18.4	16.5
Russell 2000 Growth	17.9	20.8	86%		17.9	17.0	19.4	18.0
Russell 2000 Value	15.6	16.4	95%		15.6	14.8	17.3	15.4
MSCI EAFE	14.0	17.6	79%		14.0	13.6	15.9	11.4
MSCI EAFE Small-Cap	14.0	17.7	79%		14.0	13.6	15.8	11.4
MSCI EM	17.9	16.7	108%		17.9	16.4	24.9	8.8

Source: Factset

Note premium price for emerging markets ...

Chart 2: Forecast growth rates: Bottom up by index

INDEX	Median FY1 Growth Rate							
	Current 7/28/2010	13 Year History Average	Current/ LT Average		Current 7/28/2010	6/29/2010	12/31/2009	9/30/2008
Russell 1000	13.5	11.4	119%		13.5	13.2	-5.1	9.0
Russell 1000 Growth	17.7	14.8	120%		17.7	17.0	0.0	13.7
Russell 1000 Value	8.6	8.4	103%		8.6	8.7	-11.7	3.7
Russell Mid Cap	13.6	11.2	121%		13.6	13.4	-5.8	8.0
Russell Mid Cap Growth	18.2	15.3	119%		18.2	17.1	-0.6	13.5
Russell Mid Cap Value	8.5	7.8	110%		8.5	9.2	-13.3	2.8
Russell 2000	12.1	10.7	113%		12.1	12.7	-10.2	4.6
Russell 2000 Growth	16.4	15.0	109%		16.4	17.0	0.0	11.6
Russell 2000 Value	8.3	7.7	108%		8.3	8.3	-18.8	-0.6
MSCI EAFE	12.0	7.9	151%		12.0	12.0	-6.8	4.1
MSCI EAFE Small-Cap	12.0	15.6	77%		12.0	11.9	-7.2	4.0
MSCI EM	28.7	15.4	187%		28.7	28.3	13.8	12.7

Source: Factset

... is lagging the extraordinary increase in earnings expectations.

“Global Brand Exporters” in the United States are surging as US dollar sags

Chart 3: Total Return through August 9, 2010

	MTD	QTD	YTD
R1000	2.45	9.57	2.56
R2500G	1.78	8.58	6.60
RMCV	2.22	9.84	8.87
R2G	1.24	7.93	5.44
R2V	1.46	8.70	6.92
R2500V	1.08	8.52	6.82
EAFE	3.79	13.63	-1.40
EAFESC	3.50	12.44	4.45
MSCIEM	2.54	11.08	4.23
GMC GBE	2.54	12.10	3.39

Source: Factset

The Global Brand Exporters (GMC GBE) have been surging this summer and erased poor relative performance through May.

We created this index late last year to approximate equal-weighted returns of the largest companies listed on US exchanges, with a high percentage of revenues sourced from outside the country. Returns have been sensitive to the ups and downs of the USD but have also legitimate growth opportunities in Emerging Markets.

The GBE Index Definition:

Russell 1000® screened for companies >\$10 billion; 2 independent estimates of foreign (also Asia + EMkt) sales as % of revenue>25%. Names were screened so sectors and factors were nearly sector and factor neutral other than foreign/emerging markets sales bias. We created the index in fall of 2009 and invest in it with a portion of our GMC fund.

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