

Show Me the Money

Todd- Veredus Relative Value Team Q4 2009 Review and Outlook

The fourth quarter saw the continuation of the uptrend the markets experienced in Q3, but a rotation towards stocks with the soundest fundamentals. It was like investors were saying “Show Me the Money!” The S&P ended the year at about 1120, a significant gain from the beginning of the year price of 903. Total return for the year was roughly 26%, much better than anyone would have predicted in the first quarter of the year. We believe the market is in the midst of a multi year run that will likely move the markets higher, though we would point out that it probably will not move in a straight line. We think several trends are likely to show up in 2010, including:

- The economy will continue to recover and should move into expansion at some point.
- Short rates are too low at this point, but the Fed will probably leave them alone until employment improves.
- Volatility will probably stay lower than last year, but investors will continue to fear it.
- Earnings are recovering, especially for the US multinationals. We expect this to continue.

There are risks, most notably the sovereign debt problems we have seen in Dubai, Greece and elsewhere. We still think US stocks should gain this year, and the RVE portfolio is overweighted in technology, industrials, materials and consumer discretionary stocks to take advantage of the recovery. We continue to think economic growth could be better than most investors anticipate.

What factors worked in the quarter?

Investors said “Show Me the Money” during the fourth quarter, and companies that exhibited fundamental strength did the best during that time frame. This was a change from the prior quarter, where investors wanted high volatility and cheaply valued stocks. The group that has been the most volatile and had low valuations is the Financials. They were leaders in the third quarter, but significantly lagged in the fourth.



The chart to the left shows the performance spread between the top and bottom quartiles for the factors listed. Stocks that showed investors the money, i.e. repurchased shares, grew earnings, raised estimates or paid dividends were the outperformers. Large companies with attractive valuations, low debt and good quality lagged. One surprise was that a high dividend yield helped relative returns for the first time in over two years. As the economic recovery matures, investors will probably bring quality and value back into favor when making investment choices.

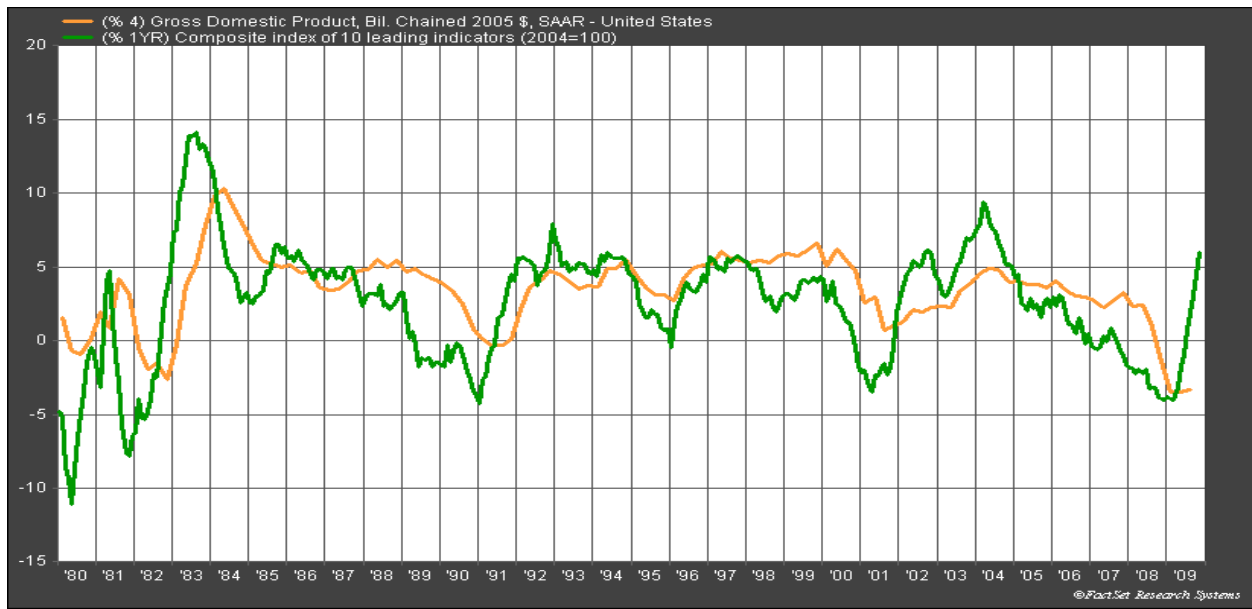
Source: Bloomberg, Factset, Ford Investor Services. S&P 500 companies



Leading Economic Indicators DO lead GDP growth!

The chart below compares the index of leading economic indicators (LEIs, green line) with real GDP growth (orange line.) As you can see, GDP growth generally follows an improvement in this indicator by about 6 months. Recently LEIs improved to a 6% expansion rate on a year over year basis. This leads us to believe the recovery is real and sustainable. Much of the economic growth we expect is likely to be centered on inventory rebuilding, meeting pent up consumer demand and an improvement in US exports.

LEIs vs. GDP Growth

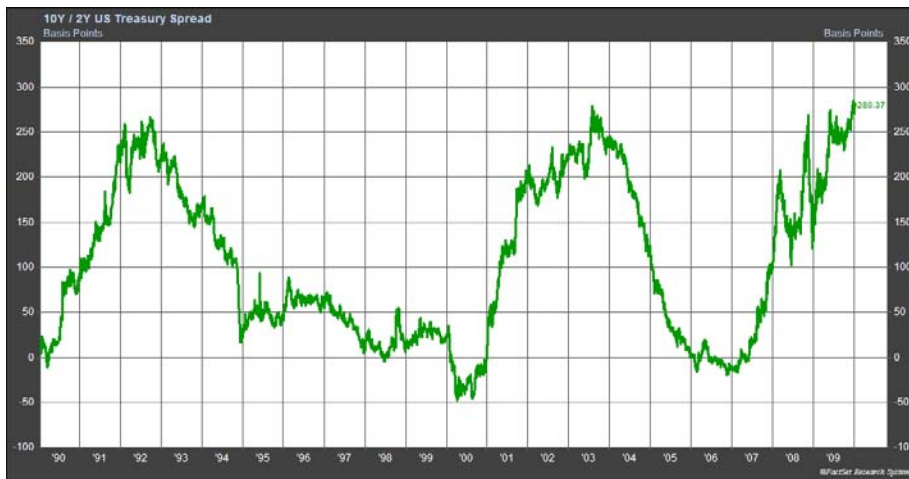


Source: FactSet

What about rates

Short term interest rates are much lower than longer term rates, as seen in the chart below comparing 2 year yields with 10 year yields.

Spread between 2 year and 10 year government bonds



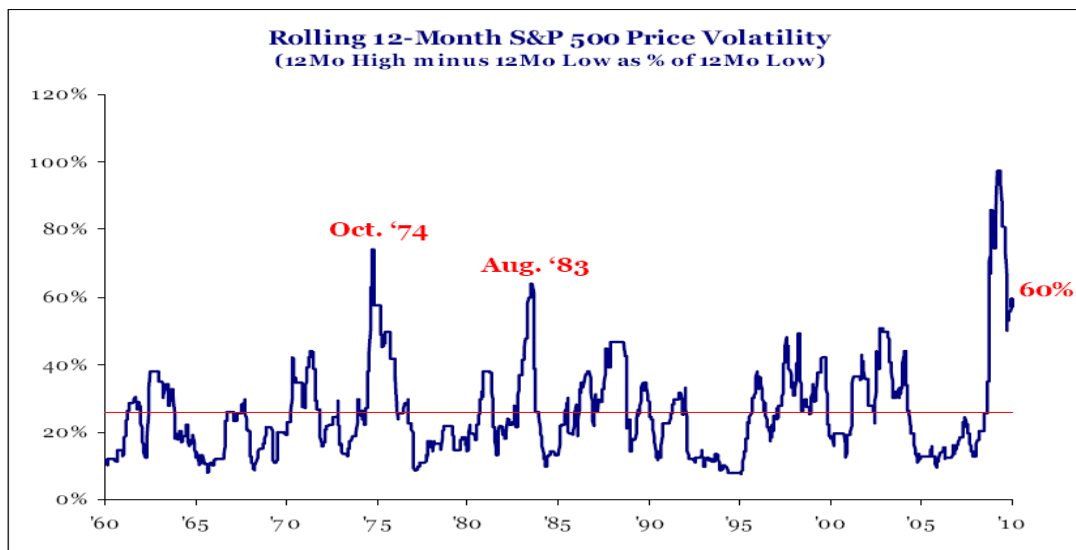
This spread is at record levels, suggesting that the Fed will need to raise short term rates at some point. History suggests the spread is about as high as it will get. If the economy picks up, the biggest surprise we could see over the coming year is the Fed raising rates. We do not anticipate this, but a strong recovery could change this view.

Source: FactSet

Volatility- Declining from a recent peak

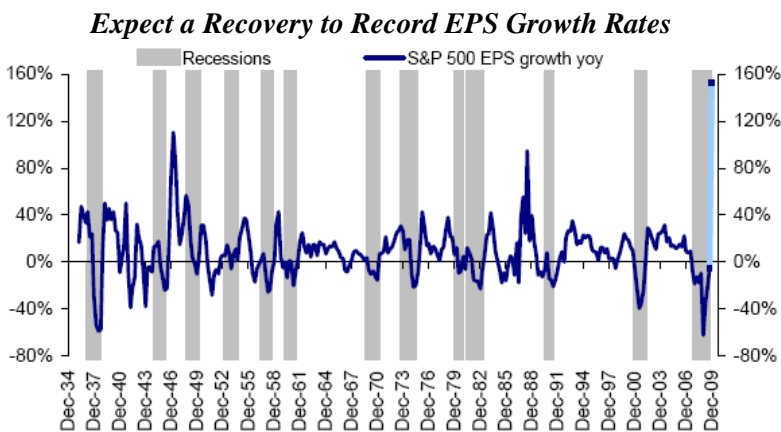
Investors remain afraid of volatility. They have been buying bonds and generally avoiding stocks over the past year. For instance, equity mutual funds saw a net outflow of \$12 Billion in 2009, while bond funds experienced inflows of up to \$320 Billion by some estimates.

Investors will probably remain concerned about equity volatility over the coming years, but our sense is that we have seen the peak in volatility for this cycle. Equity returns over the past 10 years have been among the worst on record. We believe the next 10 years will have better returns, and investors will begin investing in stocks as this volatility recedes.



Source: Strategas

Earnings are set to surge



Source: S&P, Haver, Bloomberg, Deutsche Bank

According to Deutsche Bank, the longest earnings recession since the Great Depression is likely to be followed by a tremendous snapback recovery. Companies have been very aggressive in cutting costs, and as revenues improve with GDP the bottom line should improve dramatically. We are finding that earnings estimates are increasing with each passing quarter.

How did we do?

Our Relative Value Equity accounts generally matched the indexes during the quarter. We ended the year well ahead of the value index and slightly behind the S&P 500.

Matching the index for the quarter is probably better than we deserved! At this stage of the market recovery, investors have sought more volatile companies, and not focused as much on the larger, high quality companies with attractive valuations. Our style is focused on larger, higher quality companies. Market cycles have distinct phases and last year was an early recovery year, much like 2003. During early recovery year, investors seek out riskier, lower quality investments. The premise behind this is that if a company has survived the worst of a recession then it has high leverage to a recovery. In practice, this means that companies that were most worrisome during the bear market, and were probably driven to very low prices, become the standouts of the early recovery. If a stock goes from \$50 to \$3 because investors fear they will default, it can easily move to the teens when it becomes apparent they will not default. That was the nature of 2009, and if you examine the best performers during the year, our guess is they will match this pattern. As you move into a later phase recovery, investors tend to return to the higher quality names. We expect that to occur this year.

A traditional economic recovery is unfolding, and we think that growth could be better than anyone expects in the first half of 2010. To take advantage of this, we have recently raised our allocation in the Consumer Discretionary stocks through the purchase of several retailers focused on the off price and dollar store segments. Current trends in place suggest the “Frugal Consumer” that my partner Bos speaks about, is a phenomenon that will be with us for some time. We want to take advantage of that trend.

We have maintained our overweighting in Technology and Industrial stocks. During the year, we have expected these areas to benefit from the trend of dollar weakness and better exports. The stocks have benefitted from these trends, and the technology group was the best performing group for the year. As we move into 2010, our sense is that the Industrials and other later stage cyclical stocks will probably have their time in the sun. We have moved to an underweighting in the consumer staples and other defensive stocks over the past year, and expect to maintain a below market weight in those names. History suggests it is the wrong part of the economic cycle for defensive stocks to outperform. If the prospect of a double dip recession becomes likely, we will revisit that underweighted bias.

Jack White, CFA
Partner, Senior Portfolio Manager
Todd-Veredus Asset Management LLC
01-19-10
S&P 500- 1136

Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment. This publication contains the current opinions of the author but not necessarily those of Todd-Veredus Asset Management, LLC. Such opinions are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable but not guaranteed. **Past performance is not indicative of future results.** No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission of Todd-Veredus Asset Management LLC. © 2010 Todd.