

Dynamic Allocation Field Guide January 2010

Never Let a Crisis Go to Waste

...Or, even the next one(s) that may be already fast approaching...

Something's got to give

So said The Economist (January 9, 2010) in their headline article and cover page on "Bubble Warning": "...Investors tempted to take comfort from the fact that asset prices are still below their peaks would do well to remember that they may yet fall back a very long way. The Japanese stock market still trades at a quarter of the high it reached 20 years ago. The NASDAQ trades at half the level it reached during dot-com mania. Today the prices of many assets are being held up by unsustainable fiscal and monetary stimulus. Something has to give."

Steve Mandel of Lone Pine Capital adds from his 3Q2009 Lone Cypress Quarterly Letter: "With central banks around the world working hard to re-inflate an asset bubble, the most operationally and financially leveraged companies saw their stock prices rise the most. During the quarter, there was an almost perfect inverse correlation between business quality and stock price performance."

Gillian Tett, of the Financial Times, asked (November 23, 2009): "Will sovereign debt be the new subprime?...It is easy to imagine that some countries will end up eroding the value of their bonds by debasing their currencies." Is Washington listening?

Apparently not. In contrast, Washington concocted a punitive tax and tariff all rolled into one and call it a "Financial Crisis Responsibility Fee" to be levied primarily upon banks who are not responsible for the losses and nine of whom are subsidiaries of foreign financial institutions. Corporate/Treasury spreads are widening again while small business and consumer credit continues to dramatically contract at a rate more than *triple* what economists recently estimated - \$17.5 billion versus an estimated \$5 billion contraction in November, 2009 alone - the biggest drop since records began in 1943.

U.S. households are bravely deleveraging, having moved from overspending above their incomes by 13% to saving at the rate of 4%. Conversely, government spending has expanded so much that U.S. private and public debt amounts to 5.5 times the GDP - and continues to increase - the most in human history. 37 of 50 states are generating budget deficits. Public pensions and municipal bonds are on any prudent investor watch list.

Brother - can you spare a billion?

Literally. The WSJ reported as this is written (January 16-17, 2010): "Leveraged Loans Ramp Up - Record Defaults in '09 Spur Sales as Firms Exit Bankruptcy". In amazing, matter-of-fact language, the article leads: "A record number of corporate defaults last year are driving sales of new leveraged loans in 2010...More than \$2.5 billion of exit loans already are being prepared this year, accounting for 42% of new institutional leveraged loans announced since January." Global deleveraging is going to take a very long time.

Hedge - yes - that means taking advantage of rational bubbles, while managing downside risk. Our Macroeconomic Tradewind Themes still prevail, our Tactical Roadmap - updated with a nod to M&A growth to support corporate expansion through acquisition while top-line growth stagnates - reflects some triggered, opportunistic inflection points, and cash persists as a strategic asset class (and, rates *will* go up eventually).

Game Plan

Stay nimble! We said it before and repeat it here: take advantage of emerging trends such as persistent near-term credit deflation and the timing of re-emergent inflation and more frequent, intermittent volatility spikes.

In the meantime, Bernanke continues to make it really tough to stay in dollar-denominated cash since there is definitely an opportunity cost involved. Where available, risk is better managed by allocation to liquid, uncorrelated strategies that potentially may pay better than cash while gradually building macro positions that express views regarding credit, interest rates and currencies.

SCA's priority allocation preferences are:

Global Macro, and Emerging Debt/Currencies: Permits nimble navigation of opportunities in global yields and currencies, in the context of longer term dollar devaluation.

Credit Catalyst Strategies: mortgage (especially commercial) and corporate debt dislocation opportunities.

Global Resources: Confronts long-term Inflation expectations and dollar devaluation, but reflects a natural hedge in the short-term while there is credit deflation. China has managed the world financial crisis into a worldwide resource bank at advantageous strike prices.

Relative Value/Market Neutral Strategies: Takes advantage of arbitrage and dispersion between securities, as well as market neutral event strategies.

Managed Futures: Takes advantage of trends in commodities, currencies, interest rates and equities as they emerge and evolve over time.

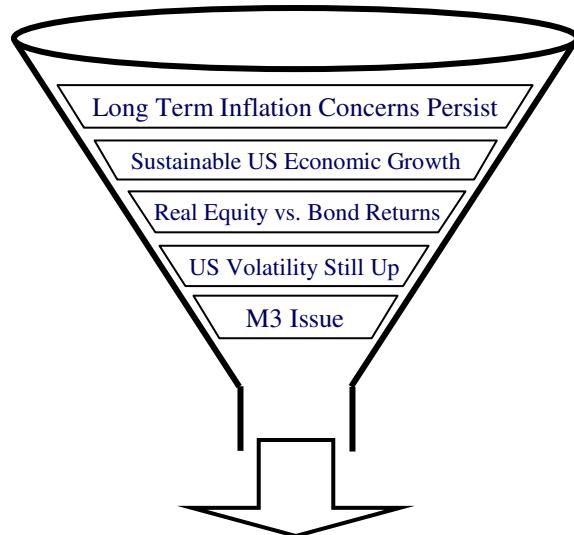
“Hedge” is the key component of this game plan. Because, as both Forrest Gump and Alexander Ineichen have recognized so well, “Life is like a box of chocolates” (Act III, December, 2009). You really do never know what you are going to get. Ineichen calls 2000-2009 “...a *loss decade* for the long-only equity investor. The US stock market, for example, started the decade at 100 and will end it at around 80. The average hedge fund investor on the other hand started the decade at 100 and will end at around 180...The funny thing is that hedge funds seek *absolute returns* but it is their *relative returns* that put them on the agenda of the institutional investor. Given that most investors are expecting that both equities and bonds will continue to experience extreme volatility in the next decade, the value proposition of hedge funds – upside optionality while actively controlling potential loss of principal resulting in continuous positive compounding of capital – looks rather attractive *relative* to everything else.”

Finally, we re-confirm and extend – yet again - what we wrote in our June, 2008 Field Guide - Investment performance expectations must be considerably tempered for the next market cycle, especially in the next 2 to 3 years. While there is the potential for global recovery throughout 2010 and into 2011, it is not likely to be robust, and it must face and overcome meaningful challenges, not the least of which is a daunting global deleveraging. But, as always, major dislocations and uncertainties provide talented investors with an opportunity to derive uncorrelated value.

Distilling Macroeconomic Themes into the Dynamic Allocation Discipline

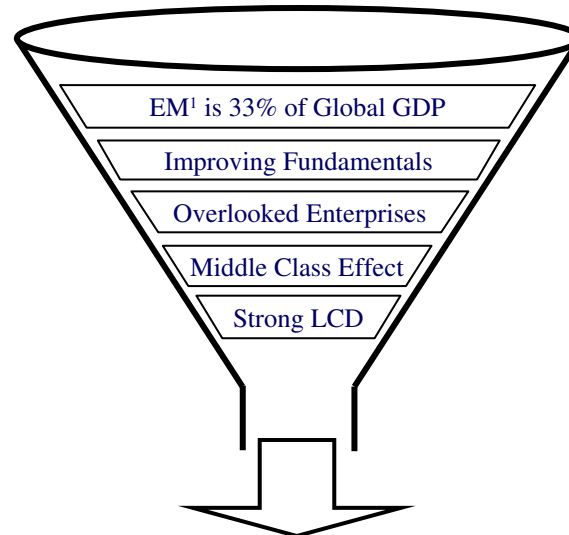
The confluence of US pressures, the RDE² Information Gap, and the Imperative Pursuit for Resources laid the foundation for SCA's current Macroeconomic Tradewind Themes since 2005.

US Pressures



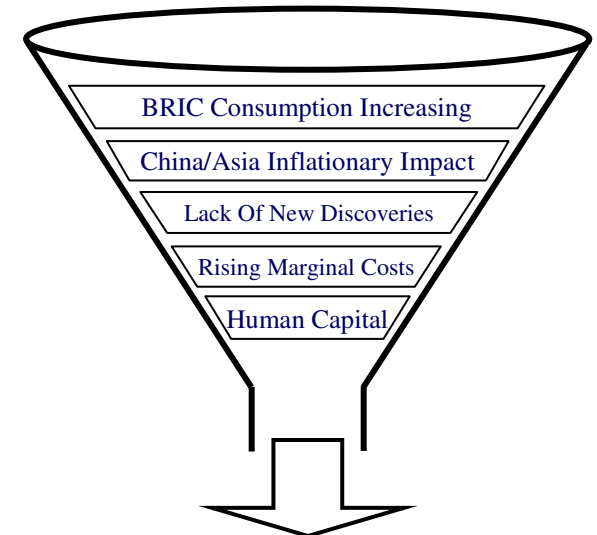
Concerns Persist Around US Inflation, Growth and Pressure on the Dollar

RDE² Information Gap



RDE (Rapidly Developing Economies)² and Emerging Market Fundamentals are Strong and Investor Advantage Derives from the Information Gap

Imperative Pursuit for Resources



Globally, Companies/Countries Compete for Resources towards "Sustainable Financial Productivity"

SCA's strategic perspectives distill from pertinent macroeconomic themes, and associated inflection points & tactical drivers.

Source: ¹ World Bank ² Boston Consulting Group

This presentation is for illustrative purposes and is intended only as an example of how SCA utilizes economic themes with its investment discipline. This is not intended to be a prediction or investment advice.

Dynamic Allocation Roadmap

- Tactical Deployment of Cash as a Strategic Asset Class -

