

Dynamic Allocation Field Guide
January 2011

Eyes Wide Shut

“Great is the power of steady misinterpretation.”
Charles Darwin

Demography is Destiny

Here are the inexorable facts – barring global war, pestilence, mega-meteors or the collapse of Facebook. Today the world has 6.9 billion people, of which the middle class is represented by 1 billion in the developed world and 500 million in the developing world. According to Jim Wolfensohn, the World Bank estimates that in the not too distant future – the middle class will grow to roughly one-half of the world’s population, 1.5 billion in the developed world and 3 billion in the developing world.

Commodity prices are on steroids already, where we have insufficient resources and capacity for today’s demands, let alone that of half of the world demanding more homes, cars, refrigerators, iPads, and leisure outlets.

This reality is not lost on long-term planners extraordinaire – like the Chinese. Their leaders and legion have fanned out across the world, notably in Africa and South America, to establish sources for their growth engine as they evolve from an explosive export economy toward feeding the needs of their domestically rising consumer demands from a growing urban/suburban middle class. Dr. Jerome Booth of Ashmore emphatically dispels the fancied bubble theory of Chinese and larger EM growth: “Emerging markets (EM)...allocations are largely from institutional investors, permanent and structural – the opposite of bubbles”. To enable this transition toward greater domestic consumerism, the Yuan will be permitted to continue to appreciate against the dollar and a larger basket of currencies and become a reserve currency in its own right.

In the last two years, two historic milestones have been breached to shatter the complacency of developed economies: greater Asia is China’s largest trading partner versus either the US or EU, and local currency EM debt has exceeded hard currency EM debt (dollar or euro-based). Still, the US and EU are mired in delusion and denial.

Liberace Would Smile

A stronger Chinese currency will likely do more to correct fifteen years of U.S. job exportation and unemployment than the ill-advised QE policies that continue to fill seemingly infinite coffers of cash whose dollar velocity is the equivalent of a high-octane engine in Park. Mohammed El-Erian recently noted for the EU (and equally relevant to the US) that he would “...rather not fantasize that a liquidity approach can overcome a solvency problem – and it will not”. The US and EU are manufacturing enough new bubbles to overwhelm the stage-set of Liberace.

Instead of dealing with and correcting structural weaknesses in housing (Fannie and Freddie have yet to be dealt with), finance (inefficient regulation), banking (the zombie banks are still carrying unresolved toxic assets), taxes (codes that encourage growth and investment versus profligate public spending and the very real bubbles of public entitlements) and healthcare (tort reform and value-based competition across state lines) at their root levels of malignancy, the scourge of US public policies is short-term thinking (to paraphrase Byron Wien in reference to the investment business – equally relevant). Thus, the necessary private and public deleveraging process will still take another 3-5 years, at least. And, domestic corporate profitability has been derived more from shrinking to an efficient core than from top-line sustainable growth - and lauded corporate Capex has (especially for Tech) focused more on labor-saving spending than from capacity expansion to meet re-generated demand.

Where's the beef?

Emerging Markets. Or, as Boston Consulting Group wisely dubbed those EM countries of most interest: rapidly developing economies (RDEs). China has implemented the start of a highway building program that dwarfs the US interstate system enacted under Eisenhower in the late 50s that served as a mobility-greased highway of growth on many levels. While the US was recently graded a generous "D" for its infrastructure, Singapore stood out as a world leader with a well-deserved "A", alongside other Asian countries. Math and science student test scores reflect a similar chasm between the US and a host of RDE countries. In any given year, about 350,000 Chinese students and an equal number of Indian students study abroad in developed countries, while less than 4,000 US students find their way to either of those countries. Would you venture a guess as to how many US students study and speak fluent Chinese (Mandarin or Cantonese, etc.) or Hindi?

In order to meet the intense, short-term and sustainably long-term demand for resources, resource-rich countries have stepped-up Capex, especially in such sectors as mining. Take Australia, for example; an Asian business periodical reported last Fall that the net present value of planned Australian mining Capex is roughly equivalent to 60% of Australia's 2009 GDP. Make no mistake, mining suppliers, including those from the US, will benefit. The Financial Times recently noted companies like Weir Minerals, Joy Global, Sandvik, Komatsu and Caterpillar.

Money managers like Cantillon, whose global core approach identifies companies with strong sustainable financial productivity (SFP), has noted that companies reflecting high SFP also exhibit strongly positive ESG (Environmentally Sustainable Growth) characteristics. China has emerged as an ESG world leader, designating 2% of its GDP annually to ESG projects in areas such as Cleantech and alternative energy, recognizing a significant Achilles' heel to their sustainable growth story. About 30% of China's water supply is too toxic even for industrial use, and its three major rivers flow away from its principal interior growth centers that have been expanding at about a 15% annual economic rate. While China must solve its persistent, widening income disparities and a low ratio of consumption to GDP with anemic increases in living standards, private consumption and wages have been growing at an impressive 8-10% annually, according to Yukon Huang in the Financial Times. Yet, these challenges reflect investment opportunities in Chinese efforts to both recognize and address these issues. Other RDEs, such as Brazil, are dealing with similar issues that give rise to equivalent investment potential in education, infrastructure, housing, services, etc.

Game Plan

The essential investment criterion is to identify and to deploy to such investment opportunities while immunizing against a cascade of Black Swans du jour: Black Oily Swan (BP environmental risk), Black Opaque Swan (Bear Stearns transparency risk) or Black Bloated Swan (AIG governance risk), for example.

Now, what of the Black Swans germinating in the moat of denial and delusion? First, there is the Black US Debt Swan – 60% of US debt matures in the next 3 years in an era of \$1+trillion budget deficits and unresolved public entitlements. Then there is the Black Municipal Swan – more than 10% of the muni market is in complex floating rate bank credit lines, or VRDOs (Variable Rate Demand Obligations), and a third of these are maturing in the next year in an environment of Basel III–constrained banks and the inevitability of much higher refinancing interest on the backs of already hemorrhaging muni coffers. And, the Black Immobility Swan – 23% of US housing is underwater with mortgages exceeding fair market value – even when jobs become available, how will candidates unload existing housing to move to those opportunities?

Exacerbating the muni problem is the CRE (Commercial Real Estate) Black Swan - \$1.4 trillion investment grade CREs must be refinanced by 2014, and about half of these are also underwater where the mortgage is greater than current market value.

Finally, and certainly not at the end of the list would be the EU Zombie Countries Black Swan – Germany, France and the UK hold over \$1 trillion of the sovereign debt of Portugal, Spain, Ireland and Greece.

Any one of these potential Black Swans are serious on their own “merit”. Imagine the cumulative effect of two or more of these coalescing into an economic super nova.

It is essential, from SCA’s point of view, to dynamically build and manage investments across a portfolio of uncorrelated risks in order to unleash sustainable upside potential. Agility is central to this approach.

SCA’s priority allocation preferences persist in 2011:

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

Mortgage Strategies: Offer attractive risk/return tradeoffs since mortgages (residential and commercial) are priced to reflect the scenario that oversupply will continue with higher interest rates and defaults.

Credit Catalyst Strategies: Corporate debt dislocation and bank loans offer attractive opportunities as opposed to high yield debt that is priced assuming default rates remain very low.

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, just as we emphasized a year ago. 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 80. The average hedge fund investor on the other hand started the decade at 100 and will end it 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 SCA 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.”

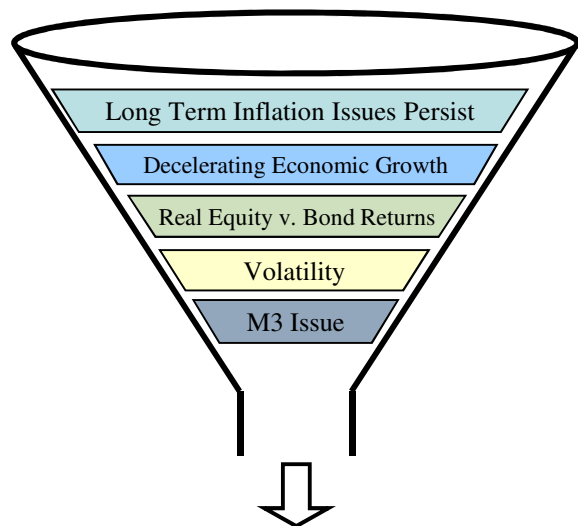
Finally, we re-confirm and extend – yet again - what we wrote in both our June, 2008 and January, 2010 Field Guides - Investment performance expectations must be considerably tempered for the next market cycle, especially in the next 2 to 3 years. While there is the potential for global recovery throughout 2011 and into 2012, it has not been and is not likely to be robust, and it must continue to face and overcome meaningful challenges, not the least of which is a persistent, daunting global deleveraging. But, as always, major dislocations and uncertainties provide talented investors with an opportunity to derive uncorrelated value.

The Macroeconomic Tradewind Themes and Tactical Roadmap are attached

Distilling Macroeconomic Themes into the SCA Discipline

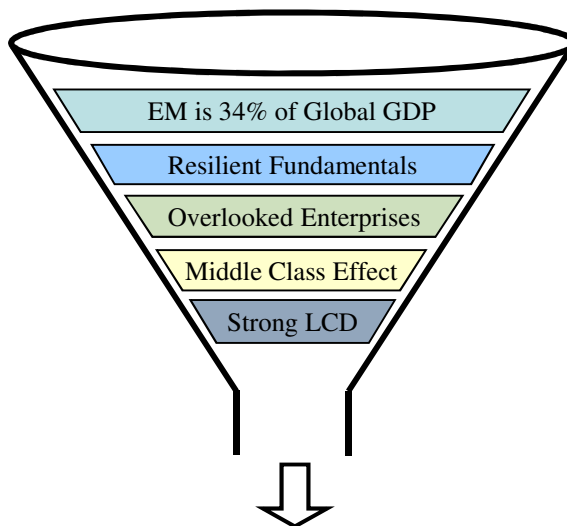
The confluence of US-EU pressures, the RDE Information Gap, and the Imperative Pursuit for Resources lays the foundation for SCA's Macroeconomic Tradewind Themes.

US-EU Pressures



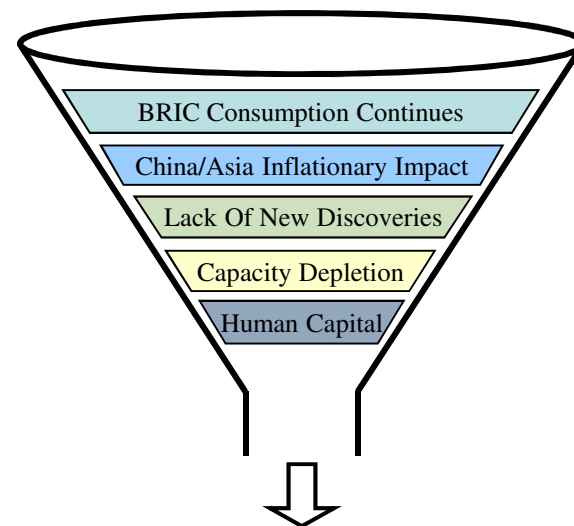
Concerns Persist Around US-EU Near-Term Deflation and Long-Term Inflation, Growth and Pressure on the Dollar-Euro-Pound

RDE Information Gap



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

Imperative Pursuit for Resources



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

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

Dynamic Allocation Roadmap - Tactical Deployment of Cash as a Strategic Asset Class -

