

## MDE 2009 Year In Review

January 2010

### **A GLANCE BACK ON THE YEAR THAT WAS**

Before we can look forward to 2010, we feel it is only appropriate to assess the accuracy of our prior year themes on which our investment policy was based. We realize the inherent difficulty in making forecasts and fully expect to never be 100% correct. Nevertheless, we are pleased to report that six of the ten forecasts we made last year, in our view, were assessed to be correct. Three forecasts were partially correct and the remaining one was incorrect according to our analysis.

Where did we go wrong in 2009? In short, we misjudged the market's perception of risk and the ensuing magnitude of its recovery in the face of a continually weak economy and long term structural problems. Specifically, with respect to our 2009 themes, we believed that in a difficult economic environment the market would effectively separate the strongest firms from the weakest firms. However, "low quality" firms led the market in its historic rebound, due in part to short sale covering and a bounce back from severely oversold levels. Economic fundamentals have remained weak, even in the face of the markets' rebound since March. Our view was that fundamentals would dictate security prices, as investors begin to discriminate between strong and weak companies. This view was not vindicated in 2009. For example, large capitalization stocks and those that pay dividends are two common metrics of quality. Small capitalization firms that do not pay dividends are often considered speculative or lesser in quality. In 2009, the Russell 2000 Small Cap Growth Index returned 34.5% versus a rise of only 19.7% for the Russell 1000 Value index, which is dominated by large capitalization dividend paying firms. Those firms that pay high dividends fared even worse.

The glass was half full or half empty, depending on your perspective, for three of our forecasts for 2009. We entered 2009 with a very defensive posture given the myriad of uncertainty that surrounded both the financial markets and the economy. This approach was well rewarded through most of the first quarter as markets imploded while talk about nationalization of some major banks seemed to gain traction in the face of increasing uncertainty as to their solvency. However, this extreme fear rapidly dissipated as the Treasury gave the major banks passing grades on the government designed “stress test.” This allowed banks to repair their balance sheets through a combination of equity raises and a relaxation of the “mark to market” rules. The “toxic asset” issue, which gave rise to unprecedented levels of fear, was cast aside by the markets as these assets were no longer required to be marked to market. This troubling issue, which TARP was originally designed to help solve, has not gone away; it has simply been camouflaged by banks’ ability to raise capital based on the government designed stress test. Although the number of bank failures increased in 2009 to approximately 140, and more than 100 were sold to stronger financial institutions, there was not the wave of big bank mergers that we expected. The most transformative bank mergers (e.g. J.P. Morgan / Bear Stearns / Washington Mutual, Wells Fargo / Wachovia, Bank of America / Merrill Lynch / Countrywide) occurred in 2008. Therefore, our expectation of a “wave of bank mergers” was not fully accurate.

We also believed that the hoard of Cash that went to U.S. Treasuries in the aftermath of last year’s escalating credit crisis was a bubble and that it’s unwinding would have positive implications for riskier investments. The latter part of the prediction was certainly true, with most risky asset classes rising measurably over the course of the year. U.S. Treasury yields did rise approximately 1% at the long end of the maturity spectrum and holders of long dated Treasuries suffered losses of approximately 20%. However, this isolated movement on the long end of the curve was hardly the “popping” of the bubble in Treasury yields we expected. Yields remained subdued throughout the year over most of the yield curve, especially short-term rates which continue at close to zero. Perhaps for lack of better sovereign debt alternatives, or based on fear of actually bursting the Treasury bubble and harming their existing investments, foreigners continue to fund our ever expanding debt by purchasing Treasury instruments in spite of their paltry yields. However, it is likely only a matter of time before we see higher Treasury interest rates and lower values, although this may occur more gradually and may not be signaled by a dramatic “bubble burst.”

The last of our partial miscues was related to our views of substantial re-regulation of the financial markets, given the new political climate of 2009. While increased government regulation, such as caps on certain executive compensation occurred in the financial markets, it was far from the significant overhaul that we expected. With the Congress otherwise occupied in dealing with “more pressing” issues like Cap & Trade and Health Care, financial regulatory overhaul took a back seat in 2009. However, meaningful legislation will likely pass early in 2010. As the year came to a close, Congress was finalizing a bill that would significantly increase regulatory oversight for all large financial institutions and improve transparency in the previously opaque derivatives market. Hedge funds, and even smaller registered investment advisors, are in for increased governmental oversight. In anticipation of greater government involvement, many financial firms repaid their TARP funds and avoided onerous restrictions on executive compensation and their operating activities.

#### Report Card for MDE’s Investment Themes for 2009

Prediction	Assessment	Comments
1 The recession will extend through the bulk of 2009.	<b>Correct</b>	The “technical” recession may have ended in the back half of 2009, but the economy remains weak according to a host of economic indicators, most notably a double-digit unemployment rate.
2 Corporate defaults will continue to rise, but credit spreads will shrink from elevated levels.	<b>Correct</b>	According to Moody’s the default rate for speculative-grade bonds was 12.5% at the end of 2009, relative to 4.1% at the end of 2008. However, credit spreads between AAA and BB rated bonds shrunk from 18.0% to 6.0% over the course of the year.
3 There will be a wave of bank mergers as strong banks merge with weak banks.	<b>Partially Correct</b>	The number of bank failures in 2009 rose to the highest levels since 1992 and many of these banks (or their assets) were effectively sold to “healthy” banks. However, the largest bank mergers occurred in 2008 with JP Morgan, Wells Fargo, and Bank of America all engaging in sizeable acquisitions. Similar “mega” deals did not occur in 2009.

Report Card for MDE's Investment Themes for 2009, *continued*

Prediction	Assessment	Comments
4 The number of hedge funds will contract in 2009.	<b>Correct</b>	According to industry data provider, Hedge Fund Research, 858 hedge funds shut down by the end of 2009Q3, relative to 554 new launches. (Q4 data is not yet available). Many funds had to shut down as they had no hopes of surpassing their high-water marks after turning in disastrous investment returns in 2008.
5 Cash equivalent and U.S. Treasury securities are the next bubble, but if it unwinds it could have positive implications for riskier investments.	<b>Partially Correct</b>	Riskier investments rose sharply over the course of the year, but U.S. Treasuries remained at very low yields for much of the year, thereby not resulting in the popping of the bubble, via sharply higher interest rates.
6 There will be increased government regulation of the financial markets and involvement with financial institutions.	<b>Partially Correct</b>	Increased oversight of financial institutions and new regulations on derivatives occurred, but it was hardly the "significant overhaul" that we expected. While many large banks escaped severe restrictions on their compensation policies and business operations by paying back their TARP funds, comprehensive financial regulatory overhaul is making its way through Congress and should be enacted in 2010.
7 Unemployment will continue to increase for the bulk of 2009 and corporate earnings will be depressed.	<b>Correct</b>	The unemployment rate increased from 7.6% to 10.0% over the course of 2009. S&P operating earnings for 2009 remained more than 30% lower than those prior to the recession.
8 Consumers will reduce discretionary spending and increase savings rates.	<b>Correct</b>	The personal savings rate in the U.S. increased from 2.6% to 4.6% over the course of the year. According to a Gallup Poll, discretionary consumer spending decreased approximately 20% in 2009 vs. prior year levels.

Report Card for MDE's Investment Themes for 2009, *continued*

Prediction	Assessment	Comments
9 Fundamentals will ultimately dictate security prices, as investors begin to discriminate between strong and weak companies.	<b>Incorrect</b>	Small Cap and low quality firms generally outperformed Large Cap and high quality firms across the equity and fixed income asset classes. The market rebound was much larger than expected in the face of weak economic fundamentals and long term structural problems.
10 Commodity prices will bottom and gold will experience renewed interest due to investor concerns about the federal budget deficit, government policy, and the threat of long-term inflation.	<b>Correct</b>	Gold and Oil increased approximately 26% and 75%, respectively, over the course of 2009. Many other commodities followed suit. The U.S. federal budget deficit approached \$1.4 trillion at the end of 2009 as the Obama Administration opted for a large fiscal stimulus plan in a bid to improve the economy.

In 2009, we erred on the side of conservatism. Coming off an economically and emotionally turbulent year in 2008, we believed that “capital preservation” was the watch word in 2009. After being rewarded for this defensive posture during the first quarter, we were reluctant to chase what we still perceive to be an irrational bull market not supported by near term fundamentals and facing the head wind of long term structural challenges. As we maintained our strategic view and made deliberate portfolio redeployments and readjustments, throughout the year, on the whole our clients’ diversified portfolios posted reasonable to above average returns given the low level of risk taken throughout the year. As we enter a new calendar year, we are pleased to present our 2010 Ten Investment Themes and Five Strategic Wealth Management Themes in our companion piece, “A Look Ahead at the Year Ahead.”

*We at MDE look forward to the opportunity to discuss our MDE 2009 Year in Review with you and how these themes manifested themselves in your portfolio construction and performance. As always, we close by thanking you for your loyalty and support. We at MDE consider our relationship with our clients a symbiotic partnership. We realize our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at MDE is focused on individual and collective improvements each day.*

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