

## A Look Ahead at the Year Ahead

### EXECUTIVE SUMMARY

MDE's current investment recommendations are informed by our current view of the world. As our world view evolves, so will our investment recommendations. As of January 1, 2010, our top ten investment themes are as follows:

1. Economic growth will decelerate over the course of the year, as large government stimulus hands off to a relatively weak underlying consumer.
2. The Fed will raise interest rates, wind down some of its liquidity enhancing programs, and contract its balance sheet.
3. The carry trade will unwind and it will likely result in an increase in the U.S. Dollar versus many other currencies.
4. Residential real estate prices gradually rise on a national basis.
5. Mergers and acquisitions activity will increase.
6. U.S. consumers' savings rate will continue to increase.
7. The U.S. Government will continue to run a budget deficit in excess of \$1 trillion.
8. Large Cap will outperform Small Cap and High Quality will outperform Low Quality.
9. Volatility will increase.
10. Valuation multiples will remain flat or compress as modest improvements in economic fundamentals and corporate earnings are offset by headwinds of higher interest rates, taxes, and inflation.

Based on these Ten Investment Themes, we formulate our specific investment implementation policy, which is articulated in our Five Strategic Wealth Management Themes as follows:

1. Prepare to Invest in a Rising Rate Environment.
2. Continue to Guard Against a Volatile Market and Adapt to Changing Market Conditions.
3. Search off the beaten path.
4. Buy yield as an important component of total portfolio return.
5. Avoid traps for the unwary.

These Strategic Wealth Management Themes are formulated by our seven member MDE Investment Committee and translated into the asset allocation policy, and specific underlying investments, which comprise our Target Portfolio. Your MDE Wealth Strategist uses this Target Portfolio to build your personal investment portfolio which is specifically designed to meet your personal goals and objectives.

#### **MDE'S TEN INVESTMENT THEMES FOR 2010**

While we firmly believe that no one can know the unknowable or predict the unpredictable, we also realize that as wealth management advisors we are paid to deliver advice. So it is a core part of our job to analyze the world around us and to make investment recommendations based upon our best thinking. Our advice at MDE tends to be strategic and long-term in nature, but nimble enough to adapt to the ever-changing investment landscape.

With this in mind, we would like to share with you our thinking on some of the significant factors we believe will play an important role in the year that has just begun. Just as was the case last year, we can state with some confidence that some themes we offer for 2010 are likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major themes of 2010 are neither on our list, nor on anyone else's. For example, in 2009 the speed and magnitude of the market recovery from the March lows was unexpected by most financial prognosticators. With these important facts in mind, we humbly offer you our top ten investment themes of 2010.

**1. Economic growth will decelerate over the course of the year, as large government stimulus hands off to a relatively weak underlying consumer.**

To date, the economic recovery, and the disproportionate 2009 increases in the financial markets, have been a response to government stimulus which will continue into 2011. However, all the government stimulus in the world cannot forever mask the inherent weakness in the U.S. consumer. Despite the partial recovery in many financial markets, consumers suffered a severe economic hit to their real estate and investment portfolios. Unemployment remains at double-digit levels and businesses remain skittish regarding their hiring plans. The government cannot continue to run trillion dollar budget deficits much longer, especially with foreign investors purchasing roughly 60% of new federal debt. Eventually they will have their fill of U.S. debt, or interest rates must rise sharply to find enough investors. Both scenarios are quite stark for the U.S Treasury.

**2. The Fed will raise interest rates, wind down some of its liquidity enhancing programs, and contract its balance sheet.**

The Fed expanded its Balance Sheet from \$900 billion to roughly \$2.1 trillion shortly after the Lehman Brothers bankruptcy and the resultant liquidity crisis. It also created a host of new programs, such as the Term Auction Loan Facility (TALF), that were designed to fill the void when liquidity in conventional financial markets dried up. Perhaps the most prominent sign of intervention occurred when the Fed lowered the interest rate it charges its member banks to a bare bones level of 0%-0.25%. The Fed is fully aware that the abundance of money, temporarily masked by tight bank lending standards, and abnormally low interest rates, pose a substantial intermediate term inflation risk. In an effort to stave off out of control intermediate to long-term inflation, the Fed will raise interest rates in the latter half of the year and be a net seller of the securities in its portfolio.

**3. The carry trade will unwind and it will likely result in an increase in the U.S. Dollar versus many other currencies.**

The death of the Dollar has been greatly exaggerated, despite the persistent U.S. federal budget and trade deficits. Although we do not disagree with the notion that the Dollar is in a gradual, long-term decline relative to emerging market currencies, its outlook versus other currencies of developed nations is not quite as clear. For example, the fundamentals are arguably worse for many Euro nations facing structural higher levels of unemployment, weak demographic trends, and a

lack of innovation. Economist Nouriel Roubini and others have called attention to a growing bubble in risky assets fueled by the carry trade, which results in investors borrowing money in U.S. Dollars and deploying it in riskier assets. The carry trade effectively sells short the U.S. Dollar. As interest rate paths, sovereign creditworthiness and growth projections diverge across the globe, currency markets will experience heightened volatility. In our view, the U.S. Dollar will benefit from the likelihood of a surge in volatility, especially against the developed markets with similar debt problems (e.g., Euro, Pound, and Yen).

**4. Residential real estate prices gradually rise on a national basis.**

Although the real estate market can hardly be called robust, glimmers of hope have appeared. The Case Schiller U.S. National Home Price Index bottomed near the end of 2009 and now rests at levels similar to those seen in 2003. In our view, real estate prices will modestly increase on a national basis as fear subsides, inventory is worked off, tax incentives remain, and natural household formation ensues. Foreclosures will likely continue to increase as prior “teaser” loans are reset upward, banks end their mortgage moratoriums, and strapped consumers exhaust all of their liquid resources. However, many of these negatives have already been priced into the market. Real estate is not a national market, and local conditions will continue to distinguish the effects of the recovery among regions.

**5. Mergers and acquisitions activity will increase.**

Wall Street demands growth of public companies, regardless of a difficult economic environment. In some instances, growth is most easily obtained via mergers and acquisitions and their resultant synergies. Importantly, capital gains tax cuts from the Bush Administration are set to expire at the end of 2010. Accordingly, there is an additional incentive for non-public companies to engage in a transaction since the effective tax rates on many deals will raise from 15% to at least 20% or more in 2011.

**6. U.S. consumers’ savings rate will continue to increase.**

The solution for excessive debt is unpleasant but simple; savings rates must rise. The current U.S. consumer savings rate is 4.6% and is up noticeably from the prior years’ rate of 2.6%. However, it must rise further in order to make a dent into the massive debt carried by many consumers. Despite an incrementally

improving real estate market, consumers will not be able to tap their houses en masse, as ATM machines for the foreseeable future. In addition, continued high unemployment rates create uncertainty, even for those currently employed, causing consumers to cut back on their lifestyles. A return to thrift will be the “new normal.”

**7. The U.S. Government will continue to run a budget deficit in excess of \$1 trillion.**

A few years ago a \$500 billion U.S. Federal Budget deficit was considered to be excessive and unsustainable. The deficit reached approximately \$1.4 trillion in 2009, fueled in part by a number of “one time” government stimulus programs and bailouts. However, in spite of protestations to the contrary, Congress continues to spend the people’s money with abandon, and will likely continue to do so in the 2010 election year to fuel the recovery. The dearth of tax receipts from weak consumers, businesses and unused capital loss carry forwards, plus increased expenditures for new entitlement programs (e.g., evolving national healthcare program) virtually ensure a massive sea of red ink for the U.S. government as long as the eye can see.

**8. Large Cap will outperform Small Cap and High Quality will outperform Low Quality.**

The 2009 rally in low quality assets was somewhat surprising, but explainable with the benefit of hindsight. The markets avoided financial Armageddon and companies that were left for dead sprung back to life. Nevertheless, the economy is riddled with negative issues and uncertainties despite the end of the recession. In a tough sledding environment, the strongest companies usually come to the fore. Accordingly, we believe Large Cap, high quality companies are poised to lead the market in the year ahead. Dividends are often a material component of the return for quality firms. However, many dividend payers were not rewarded in 2009 due, in part, to investors’ desire to avoid potential dividend cuts. As some dividend payers were forced to cut or eliminate their dividends early in the year, many solid dividend payers were hurt in sympathy as investors sold first and asked questions later. In our view, this sorting process largely played out in 2009 and we believe that investors will reward high quality dividend payers in year ahead.

**9. Volatility will increase.**

The 26.5% rise in the S&P 500 over the course of 2009, and 68% rise from its March 6 intraday low, resulted in a more than 50% drop in equity volatility (VIX). The 80% decline in the TED Spread, albeit from historic levels, provides yet another indicator that the pricing of risk has declined measurably. In our view, the risk aversion pendulum has swung a little too far to be justified by the economic fundamentals. We expect the VIX to increase from its year end 2009 levels of 19.5 as the momentum from the post March 6, 2009 recovery wanes and markets look for direction.

**10. Valuation multiples will remain flat or compress as modest improvements in economic fundamentals and corporate earnings are offset by headwinds of higher interest rates, taxes, and inflation.**

The S&P 500 is trading at approximately 15x forward earnings and 25x trailing earnings, not an outrageous level, but one that is probably not warranted given modest expected growth and the likelihood of higher taxes, interest rates and inflation. These forces act as headwinds for the economy and form the foundation for our expectations of a long-term period of modest growth ahead. The net result is that we will keep a keen eye out for investments that offer the prospect of mid single digit to low double-digit returns with a relatively high degree of certainty.

**MDE'S FIVE STRATEGIC WEALTH MANAGEMENT THEMES FOR 2010**

Investment themes in and of themselves are interesting, but of little value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Themes, we would like to offer Five Strategic Wealth Management Themes for 2010, along with specific techniques to implement them.

One commonality among nearly all of our 2010 investment themes is that we believe the “bumper crop” of returns experienced in 2009 by many asset classes is unlikely to be repeated in the year ahead. We are designing portfolios that have an increased likelihood of delivering mid single to low double-digit returns, with a strong emphasis on downside protection. However, there is no free lunch; if the market repeats the surge it experienced in 2009, our Model Portfolio will likely underperform broad market indexes while achieving its target returns.

### **1. Prepare to invest in a rising rate environment.**

The days of artificially low interest rates and inflation are gradually coming to an end. Short-term interest and inflation rates of close to zero percent are clearly too good to be true and are at variance with their historical long-term averages. Although we do not believe there is a high likelihood of a huge spike in short-term interest and inflation rates in 2010, the direction of the change is nearly all but certain. The following investment ideas may be able to capitalize in a world of rising interest rates and inflation:

- We maintain a material position in several asset allocation managers, many of which have allocations to gold, commodities, real estate and other investments that historically perform well in an inflationary environment. Although a position in gold and other commodities may appear to be somewhat inconsistent with our views of an improving U.S. Dollar, commodities often rise in an inflationary environment due to an oversupply of money. This condition is likely to persist due to the previously noted sizeable expansion in the Fed's Balance Sheet and the difficulty in deftly sopping up the excess liquidity.
- We continue to invest in an emerging market income fund, run by a well known asset management firm, which invests in high quality, short-term sovereign paper. If short-term yields increase on a global basis this fund should be able to capitalize on this dynamic. Given the recent default scare in Dubai, sovereign credit risk and the prospect of contagion remains. However, this fund holds relatively short term liquid debt, maintains a high degree of diversification, has proven itself to be quite deft in actively rotating investments among various countries and has also demonstrated an ability to use cash as a risk reduction technique.
- We maintain a scaled down allocation, on the heels of excellent performance in 2009, to a master limited partnership (MLP) fund and high yield bond funds. Although these investments may be subject to some risk in a rising rate environment, they are far less subject to risk of rising rates than pure Treasury instruments and their relatively high yields (e.g. some 6%-8%) may cushion the possible loss from a rise in interest rate risk.

- We are conducting ongoing due diligence on floating rate bond funds. Since floating rate funds are typically tied to LIBOR, existing yields have not been extremely attractive. However, our views may change as short-term interest rates begin to rise. In addition, we continue to conduct due diligence on funds that historically act as inflation hedges, such as those concentrated in real estate and commodities.

## **2. Continue to guard against a volatile market environment and adapt to changing market conditions.**

Risk is higher than conventional metrics suggest, therefore, the needs for significant downside protection and Adaptive Asset Allocation remain strong. We previously noted that the somewhat benign levels of many conventional risk metrics, such as credit spreads and VIX, may be masking sizeable risks that lurk beneath the surface. For example, despite the government bailout of many banks, we still do not have great clarity on their assets, nor the risk inherent in their commercial real estate, structured finance, and credit card portfolios. Furthermore, the specter of political risk always remains with us. It may range from traditional hotspots in the Middle East to the uncertain results of the forthcoming 2010 U.S. Congressional elections. The recent failed bombing attempt on a plane destined for the U.S. and uncovering of others in the planning reopened the painful wound of terrorism and the resultant necessity to incur expenses to mitigate the possibility of future attacks. Unknown “black swan” risks are, by definition, ever present.

*Adaptive Asset Allocation* is our term for our willingness to dynamically alter a client’s asset allocation, as changes in risk / return metrics dictate. A diversified portfolio is always maintained, unlike the “all or nothing” strategy of market timing. The following investment tactics and discussion relates to our theme of being adaptive, with a heightened sense of risk control:

- Our Planned Return Strategy<sup>SM</sup> (PRS) remains a core staple in our client investment portfolios. PRS provides low double-digit downside protection, but also offers the prospect for a multiple of market (i.e. S&P 500) returns during a period of modest growth up to a low double-digit cap.
  - We may expand our Planned Return Strategy<sup>SM</sup> (PRS) program in 2010 and beyond to include an increased number of underlying return drivers (e.g., global indices, commodities) and dynamic market hedging capabilities.

- Our investment portfolios remain thoroughly diversified among the equity, fixed income, hybrid and alternative asset classes.
- Our core fixed income investments focus almost exclusively on high investment grade securities and capital preservation.
- We restate our longstanding commitment to investing on a global basis to create greater opportunity sets. We have increased our allocation to global macro asset allocation funds to make our portfolios even more adaptive by giving managers more tools in their tool box since “Black Swan” type events know no asset class or geographic boundaries.
- We have increased our allocation to liquid and transparent alternative investments, including several new hedged market neutral mutual funds.
- The vast majority of our recommended investments remain highly liquid and transparent. These concepts are central to MDE’s financial DNA.
- We maintain our willingness to opportunistically utilize Cash as a risk reduction technique, even in a low yield environment.
- We are implementing a new portfolio re-balancing system during the first quarter of 2010 that will allow us to improve the efficiency of across the board portfolio rebalancing. This will better allow us to implement portfolio changes in a relatively short period of time and with minimal margin of error.

### **3. Search off the beaten path.**

The significant rise across many asset classes last year has diminished the opportunity set for traditional investments with attractive risk adjusted returns. In essence, we have to look at underfollowed investments that are often off the beaten path in order to continue to deliver outstanding value to our clients. These prospective investments are part of our constant search for investment strategies that have different return drivers, thereby lowering the overall risk among holdings within a client’s portfolio. These strategies are typically self liquidating in nature and feature a low market risk (beta) and lower correlation to traditional financial assets. Most of these prospective investments are part of our ongoing due diligence process, and are discussed below:

- One intriguing opportunity focuses on secured financings and purchases of non-commoditized financial and physical assets. Some of the examples of this approach include settlement litigation, municipal receivables, government financings, medical liens, and estate financings. The liquidity crisis in the financing market creates opportunities for managers to craft unique solutions for borrowers that may be ignored by conventional lending sources. By valuing assets at a significant discount to their underlying cash flows and/or liquidity value, the manager achieves an increased likelihood of principal protection and attractive returns.
- We have also identified an experienced real estate team that seeks to purchase foreclosed properties around the nation that meet their stringent acquisition criteria. They purchase foreclosed properties from banks at significant discounts to current market value and use the inefficiencies in foreclosure markets to turn around and sell the homes at attractive rates of return.
- We are likely to renew our previous investment in institutional quality core real estate assets (e.g., high occupancy office buildings, apartment buildings, retail malls, and industrial storage facilities) at the appropriate time as the capitalization rates and property prices stabilize. This prospective investment may act as an important complement to our previously discussed strategies for navigating in a potential inflationary environment.

**4. Buy yield as an important component of total portfolio return.**

Yield is a separate and understandable return driver that can be derived from many sources. For example, it may come from higher yielding bonds, high dividend stocks, master limited partnerships, real estate related securities and private investments. Despite their different return drivers, some yield oriented investments may exhibit interest rate risk and are thus only part of our well-diversified portfolios. Some specific yield oriented investments are discussed below:

- We continue to maintain an allocation to one of our core equity managers that holds high quality stocks with an average dividend yield of approximately 4 - 5%.

- We hold a mix of fixed income investments that we classify as “hybrids” due to their higher than average yields and increased volatility. These various funds hold a range of assets including non-rated municipal bonds, lower investment grade to high yield corporate bonds, and sovereign securities and are all yielding in excess of 5%.
- We maintain a position in a master limited partnership fund that yields approximately 7.5%.

#### **5. Avoid traps for the unwary.**

Sometimes the best course of action is the path not traveled. The avoidance or material underweight position in assets that experience sharply lower returns or hidden risks can be of great benefit to investors. In widely diversified portfolios managed through discretionary managers, it is extremely difficult to ensure zero exposure to a broadly defined area. However, it is possible to consciously avoid making specific investments in or deliberately underweighting specific areas. With this thought process in mind, MDE is consciously avoiding or underweighting investments with certain characteristics that we discuss below:

- We continue to avoid or be significantly underweight in long-term U.S. Treasury Bonds. Despite their steep losses last year, yields on long-term Treasury Bonds are still exceptionally low by historical standards. For example, the current yield on the 30-year U.S Treasury bond is approximately 4.6%, well below its long-term average of roughly 6.5%. A gradual reversion to long term yields could have devastating consequences for investors holding these “safe” securities.
- We deliberately avoid taking duration risk by investing in long term bonds. To the extent interest rates rise, these bonds will be the most severely impacted.
- As has been our long standing policy, we continue to avoid illiquid, non-transparent investments. The Madoff fraud scandal and poor performance of hedge funds and private equity vehicles in 2008 has reinforced the benefits of MDE’s long held philosophy in the area. Although MDE may hold somewhat illiquid or opaque investments through non transparent limited partnerships for a small minority position in some client portfolios, the terms are significantly better than industry standards.

- We believe portfolios with predominant “long only” equity exposure are too risky, despite the performance of this asset class during the last three quarters of 2009. With the benefit of hindsight, a 100% long only position in equities, or high yield bonds, may have been the optimal course of action for 2009. However, a portfolio skewed towards such highly volatile, long only assets would have also been down in excess of 25% during the first quarter in 2009 on the heels of large 2008 losses. Most clients cannot, nor should, tolerate a portfolio with volatility of this magnitude. Rather, we remain committed to our long standing view of constructing diverse portfolios that are comprised of investments with many different return drivers. In our view, this approach will provide the best risk adjusted performance over the long-term.

*We at MDE look forward to the opportunity to discuss our Ten Investment Themes with you, as well as the ways in which our Five Strategic Wealth Management Themes can be custom tailored for your personal situation. 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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