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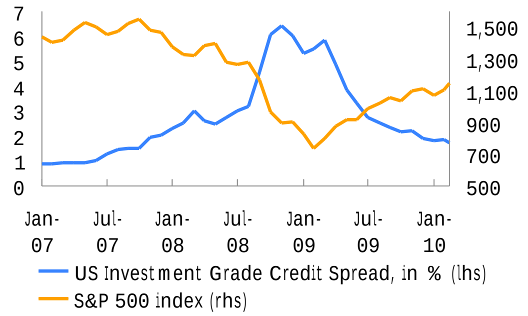
Portfolio strategies

One year after - Reengaging in a higher-risk world

- While markets have normalized, the wounded psyche of the investing public has yet to fully heal. Buffeted by two market collapses over less than a decade, individuals remain jittery about recommitting to risk assets and retain elevated cash balances.
- The portfolio de-risking that occurred due to the crisis now poses a serious challenge for many investors. The returns required to meet longer-term objectives are well in excess of what can be earned on cash alternatives and short-duration Treasury securities.
- Individuals now face a choice - compromise on their goals or else recommit to financial markets in a way that balances the need for higher returns with this newfound sense of risk aversion.
- We offer some alternatives toward portfolio repositioning in a high-risk world. We focus on strategies that emphasize a higher portion of returns in the form of current income rather than capital gains and a selective exposure to market and other risks. We also highlight qualitative assessments that are required to ensure that the incremental yield more than offsets the associated incremental risk.

Fig. 1: One year since the bottom



Source: Bloomberg, BoAML, UBS WMR

Quite a year

It was just about a year ago that the most devastating financial crisis to sweep through global markets since the Great Depression drew to an uneasy conclusion. By the time markets finally bottomed out in March 2009, the S&P 500 had fallen 57% from its prior highs and corporate credit spreads had surged to levels not seen in more than seven decades (see Fig. 1).

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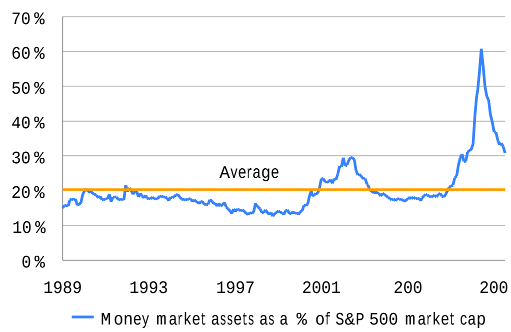
Of course, at that time there was no uniformity of opinion about what might lie ahead. Some looked upon the devastation within the financial system and foresaw an even more extended period of depressed market returns and heightened portfolio risk. Others – ourselves included – viewed distressed valuation levels and the extraordinary policy measures being undertaken as the necessary ingredients for a reflation rally that would ultimately drive a recovery in risk assets. While there have been plenty of anxious moments along the way (and there certainly will be a few more going forward as well), markets have stabilized to the extent that policymakers are now considering withdrawing some of the emergency measures put in place in the immediate aftermath of the crisis.

But while markets may have normalized, the wounded psyche of the investing public has yet to fully heal. Buffeted by two financial market collapses over the span of less than a decade, individuals are understandably jittery about recommitting to risk assets. As a result, cash balances remain elevated by historical standards as investors are still unconvinced about either the durability of the economic recovery or the stabilization that has taken place within the financial markets (see Fig. 2). The lingering effects from this crisis that wiped out a decade's worth of investment returns has prompted many to adopt more conservative portfolio positioning. But it is this overly cautious approach that may now pose the biggest challenge to investors. With the yield on most safe-haven assets well below the returns required to meet longer term objectives, investors now face the prospects for sizable funding shortfalls unless they recommit to risk assets. In this report, we explore the current motivation behind safe-haven investing and also recommend several lower-risk "reengagement" strategies for individual investors.

Fig. 2: Still very high cash balances



Source: Bloomberg, Datastream, UBS WMR

Fear and regret after a "lost decade"

As we have already noted, the global credit crisis not only wrought havoc upon investment portfolios, but also had a devastating effect upon the psyche of individual investors. Even those with seemingly well diversified portfolios suffered material losses during this crisis. Confidence has, moreover, been shattered by the proximity of the latest meltdown to both the bursting of the tech/telecom bubble and the Asian currency crisis. Events that had been projected to occur perhaps once every hundred years or so now seem to be happening with frightening regularity. Whether labeled "black swans", "fat tails" or "six sigma events," these market dislocations have impacted investment portfolios far more frequently than traditional finance theory would have predicted. With their faith in modern portfolio theory shaken, many investors abandoned risk assets en masse and sought the security of so-called safe-haven assets. As a result, some individuals adopted what amounted to a "zero-tolerance policy" for investment losses. That is, they would prefer to earn little or no return on investment in exchange for the near certainty for a return of investment.

And so it is that one year after the market bottomed out, many individuals are still sitting on the sidelines, paralyzed by a combination of fear and regret. Some fear that the economic recovery process they are witnessing will prove too shallow to be trusted and that a relapse may still lie ahead.

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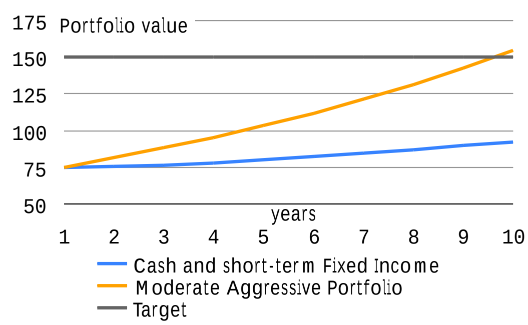
At the same time, others regret that they missed the rebound and wonder whether it may already be too late to participate in the market recovery. But while this reflexive de-risking in the immediate aftermath of the crisis is understandable, it now poses a serious dilemma for many investors. The returns required to meet any number of longer-term objectives ranging from retirement, to children's education, to philanthropic giving are well in excess of the yields on cash alternatives and short-duration Treasury securities that can be earned now and what we expect for the foreseeable future. This is illustrated in Fig. 3, which compares the average value over the next ten years of a portfolio invested in cash, short-term Treasuries and short-term municipal bonds with a portfolio invested along the lines of UBS's moderate aggressive asset allocation.

As a result, in the absence of new sources of funding, individuals must either compromise on their longer-term investment goals or else consider recommitting to financial markets in a way that balances the need for higher portfolio returns with this newfound sense of risk aversion.

Fig. 3: Low returns on cash can compromise investment goals



Source: QIS, UBS WMR; Note: This simple example illustrates the case of an investor with pre-crisis assets worth 100 and who was expecting to grow his/her wealth to 150 in 10 years to meet an important objective. We assume that the crisis has lead to a 25% loss of value in the portfolio. If the investor maintains a portfolio consisting of cash, short-term treasuries and short-term munis, he/she is sure to miss the investment objective. A more aggressive portfolio, which exposing the investor to greater volatility has a reasonable chance of fulfilling the investment objective.

A balanced financial market outlook

Keep in mind of course that such a reengagement process will still need to take place amid an environment of continuing uncertainty. The longer-term outlook remains mixed as consumers embark upon the process of deleveraging, financial institutions continue to grapple with troubled assets, governments deal with the after-effects of soaring budget deficits, and Fed officials try to figure out how best to normalize monetary policy. While financial markets rebounded sharply in response to extraordinary policy measures, we believe that markets can still post moderate gains in the short-to-intermediate term. However, we do anticipate that returns on financial assets will likely be more mixed going forward as some important secular headwinds serve to both constrain growth and restrict the options available to policymakers.

This view is based on the current combination gathering momentum in the cyclical recovery, and a still-accommodative policy mix which provide a supportive backdrop for risk assets, on one hand, but also valuation levels which now fully reflect the likely extent of the recovery, on the other. (Please see the most recent *Investment Strategy Guide* report for a more complete investment case.) Consider the following:

- The recession has ended and given way to a sluggish yet increasingly durable economic expansion. The US economy is now projected to expand at a 3% clip this year amid a combination of improving consumer sentiment, increases in business investment spending and the restocking of inventories. While fiscal challenges in Greece and other EU nations have served to dampen expectations in Europe, East Asia continues to expand at a robust pace due to improving global trade volumes, strengthening domestic demand, and heavy doses of government spending.

- Corporate profits bottomed out during 2009 amid a final wave of crisis-related write-downs at financial institutions, a recession-inspired contraction in manufacturing activity, and a paring of expenditures by a debt-burdened consumer sector. But as the headwinds from both the financial crisis and recession begin to abate, corporate profits are poised to surge over the next two years as a result of significant cost-cutting efforts, accelerating business spending, improving global growth prospects, and better operating profits within the financial sector. We therefore look for a 29% increase in S&P 500 per-share profits this year to the USD 80 level, and a further increase of 15% next year to the USD 92 level.

- Equity and credit markets have rallied sharply from the lows posted last year, as the extraordinary efforts on the part of policymakers served to reflate the economy and stabilize the financial sector. But despite an increase of almost 70% in stock prices and a narrowing of corporate spreads by nearly 500 basis points, neither stocks nor corporate bonds appear particularly expensive at current levels. According to our own valuation work, stocks currently trade about 5% below fair value while both high-yield and investment-grade credit spreads are about in line with the fundamentals. So while risk assets are no longer as compellingly "cheap" as they were a year ago, they do not appear excessively "rich" at the moment either.

- Monetary policy is still approaching a critical inflection point, as Fed officials seek to rein in an overly accommodative policy mix. This process of "normalizing" interest rates is likely to begin toward the latter part of 2010 or early 2011. Although the fed funds rate is poised to rise, in our view any increases will be limited in terms of both the size of the hikes and the number of moves. This means that money-market rates will also remain low for an extended period, thus limiting the return on cash and cash alternatives for much of the next two years.

Taken together, these considerations suggest that there is further room for risk assets to run higher during the next year, including equities, credit and commodities. However, we do need to acknowledge that the phase of the market recovery when excessively cheap valuations were helping all risk assets to generate exceptional returns is likely over. What we can expect looking forward is a much more gradual move higher with recurring bouts of volatility as experienced in the first two months of the year. While such an environment can still present investors with attractive opportunities, a much more differentiated approach to investing will be needed compared to last year.

Lost: the sequel?

Despite fairly priced markets and an increasingly supportive macro backdrop, investors with a longer time horizon may fear that the lost decade that they have just experience may be followed by a sequel. Yet, there are compelling arguments against this view. A key determinant of equity performance over any ten-year period is the level of valuation at the outset of the decade. Evidence supports the view that attractive equity valuations at the outset of a decade have usually been associated with above-average capital gains on equities during the ensuing decade. On the other hand, demanding valuations at the start of the period were typically associated with disappointing returns over the ten-year time frame. We believe that herein lies a crucial difference between the market conditions today and those that prevailed ten years ago. Current equity market valuation appears very reasonable when considered from the context of historical price-to-earnings (P/E) multiples. The P/E for global equities presently stands at about 14x next year's projected earnings, compared to a P/E multiple that exceeded 24x a decade ago (see Fig. 4). Based on these considerations, we would expect stock market returns to be more in line with long-term average performance over the next ten years and therefore unlikely to turn into a replay of the lost decade.

How to reengage: a roadmap

Our approach to moving forward is informed by both an appreciation of the effects that the financial crisis has had upon individual investors' psyche and a thorough understanding of the more limited opportunities that present themselves one year after the market bottom. Given a still-heightened sense of anxiety, we acknowledge that investors may well elect to adopt a more measured approach toward both the recommitment of liquid funds and the repositioning within investment portfolios. Instead of radical asset shifts, investors may instead wish to consider incremental changes aimed at just modest increases in overall risk exposure.

This suggests looking for investment strategies that incorporate the following:

- a higher portion of return in the form of current income;
- selective exposure to market and other risks;
- a qualitative assessment to ensure that the incremental yield more than offsets the associated incremental risk.
- a focus on alternative investments with attractive diversification properties.

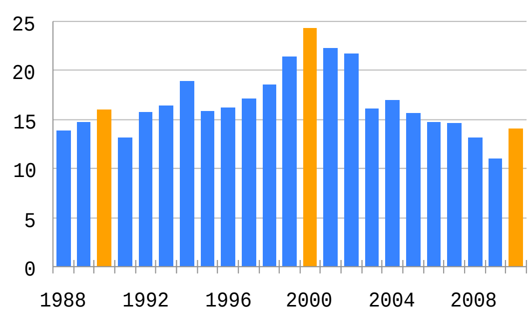
In the remainder of this report, we offer some perspective on types of investment strategies that might make the most sense for individual investors. While there are many potentially appealing investment options that investors could consider, we focus on just four: corporate bonds, municipal bonds, equities, and alternative investments. We understand that there are still concerns over how best to reengage in the aftermath of the crisis; therefore, we offer some alternatives toward portfolio repositioning in a high-risk world.

(1) Corporate Bonds: Better prospects despite more meager spreads

Investment-grade (IG) corporate bonds have long been considered an attractive investment alternative for those seeking adequate returns at more moderate levels of risk. Despite some high-profile bankruptcy filings during 2008 and 2009, most notably Lehman Brothers, General Motors and CIT Group, IG corporates have historically experienced extremely low default rates, meaning that there is fairly low risk that an investor will fail to receive either scheduled interest payments or the return of principal at maturity. As a result, IG corporate bonds should still be considered for investors who are

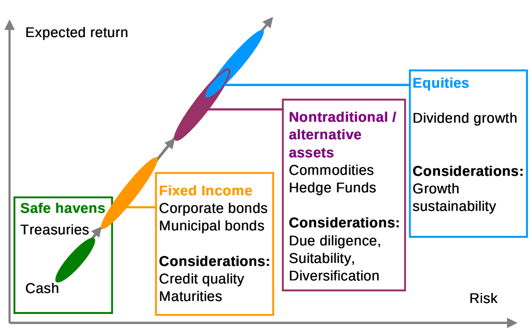
Fig. 4: Reasonable valuations to start off the decade

Price-to-earnings ratio for MSCI World equity index



Source: IBES, UBS WMR

Fig. 5: Reengagement strategies



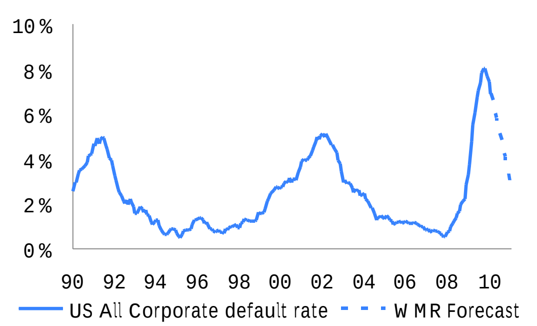
Source: UBS WMR

willing to accept moderate levels of risk and seek returns in excess of those offered by Treasuries or FDIC-insured products such as certificates of deposits.

Corporate bonds experienced one of their best years on record in 2009, as credit spreads narrowed from historical highs to average levels. High-yield corporates returned nearly 60%, while IG bonds posted a healthy 20% during the year. At this stage, the attractiveness of corporate bonds lies not so much in their extraordinary absolute-return prospects, but rather in the better relative-return prospects they offer compared to either Treasuries or cash. The yield pickup relative to risk-free assets remains substantial. Moreover, trends in corporate credit fundamentals have turned increasingly positive, suggesting that credit spreads would be expected to move either sideways or tighter over the course of this year. This in turn might offer some moderate capital-gains opportunities – or at least limit capital losses as Treasury rates rise.

Keep in mind that corporate default rates surged during 2008 and 2009 in the midst of the credit crisis and recession. However, the unlocking of credit markets and general improvement in business conditions has already led default rates to decline, a process we expect to continue over the next 18 months (see Fig. 6). As credit conditions have further normalized, fewer companies are being forced to default due to a lack of funding. Amid fewer defaults, overall credit conditions improve and corporate credit spreads tighten still further. This improvement in credit conditions then feeds back into the loop that leads to still-lower default rates to create something of a "virtuous cycle". Against this backdrop, corporate bonds should remain well supported and are likely to outperform comparable-maturity Treasury issues.

Fig. 6: Declining default rates



Source: Moody's, UBS WMR

Balancing the risks

Still, in assembling a well positioned portfolio of corporate bonds, two considerations are key: 1) the "duration" or maturity structure; and 2) the underlying credit quality of individual issues. Duration considerations must include a forecast of interest rate movements and how those rate shifts will impact the value of portfolio holdings. Credit quality discussions focus on the borrower's ability to meet its financial obligations over the life of the bond. Different phases of the economic cycle will dictate certain positioning regarding both duration and credit quality. Consider for a moment how the current outlook is likely to impact corporate bond portfolios from both an interest rate risk and credit risk standpoint.

- **Duration** – We forecast that underlying Treasury rates will rise over the next year as the broader economic recovery continues to be validated, the Fed begins to normalize policy, and the market digests record supply of Treasury debt. While we believe that rates will rise more on short to intermediate maturities, it is the longer portion of the yield curve that should experience a greater decline in price due to its greater sensitivity to yield changes. When anticipating a period of rising rates, investors should shorten the duration of their portfolios. Bonds of shorter duration will be less severely impacted by rising rates, and may offer investors the opportunity to reinvest the proceeds of maturing debt into higher-yielding securities at some point in the future. We are therefore recommending that new funds invested in IG corporates should be used to build a ladder of bond with maturities between two and seven years.

- **Credit Quality** – During periods of recovery, such as the period we are currently experiencing, investors are typically best served moving down slightly in credit quality to take advantage of tightening credit spreads. For lower-rated bonds within IG, namely those rated in the 'BBB'-category, credit-spread compression occurs at a faster rate than higher-rated bonds, leading to relative outperformance. In our opinion, 'BBB'-rated bonds offer the opportunity to pick up incremental yield at only modestly higher levels of risk. While these lower-rated investment-grade bonds may not be appropriate for all investors, they may represent an alternative to higher-risk non-investment-grade issues.

Reengagement within the corporate market requires managing risk on both the interest rate and credit fronts. Although interest rates are likely to trend higher, we do not look for a sharp surge across the entire curve as a gradual unwinding of current accommodative conditions by the Fed keeps short rates low. At the same time, the continued slow but steady improvement in corporate credit conditions amid renewed profit growth and easier access to credit should contribute to a ratcheting-down of default rates and somewhat tighter spreads. This suggests that short-dated investment-grade debt represents a potential alternative to low-duration Treasury bonds within tax-deferred accounts.

(2) Municipal Bonds: Selectivity is important amid lingering credit concerns

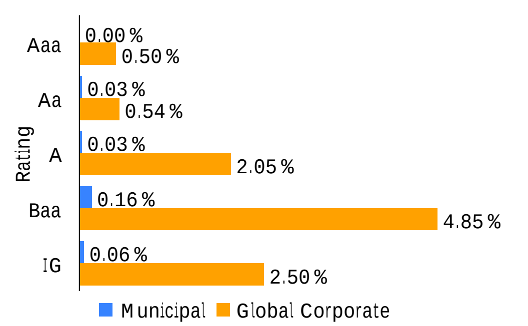
Like corporate bonds, municipal bonds spent a good part of 2009 coming back from the abyss. This resulted in exceptional returns, which are unlikely to be repeated and have removed a substantial portion of the value in municipal bonds. Moreover, there are ongoing credit problems within the municipal market that will present new challenges in the months ahead. Nonetheless, we think that portions of the municipal bond market remain attractive areas for investors to consider.

In marked contrast to last year when an attractive yield pickup could be reaped almost indiscriminately in most parts of the municipal bond market, reaching for additional yield under current market conditions almost automatically involves assuming more credit risk. Therefore, it is critical that such investments be made with a thorough assessment of the credit risk of the underlying issuers. In addition, with municipal bonds having rallied sharply last year as liquidity conditions improved, portfolio repositioning is essential to balance credit-risk exposure against more limited return prospects. We therefore look to highlight those sectors of the municipal bond market that we find the most attractive.

We do expect some credit-rating deterioration and, among high-yield issues, an uptick in default rates. However, we believe that fears of a broad credit crisis in the municipal market are unfounded. Keep in mind that

Fig. 7: Default rates are lower for munis than for corporates

Moody's 10-year average cumulative issuer-weighted default rates



Source: Moody's, UBS WMR

municipal default rates have consistently been significantly lower than for corporate bonds with equivalent ratings (see Fig. 7).

Meanwhile, massive federal deficit borrowing and gradual economic recovery appear likely to push Treasury yields higher over the next year and beyond. However, several factors may mitigate the impact of rising Treasury yields on tax-exempt municipal-bond prices including: higher future federal and state income tax rates; reduced tax-exempt supply as Build America Bonds (BABs) comprise a larger portion of municipal issuance; potential narrowing of municipal credit spreads in places such as 'A'-rated munis, where they are still unusually high.

Sorting through the alternatives

As is the case for corporate bonds, maturity and credit quality are the two main criteria that investors need to focus upon when investing in munis. As far as maturities are concerned, we favor 7- to 12-year intermediate-term munis. We view this segment as the most compelling compromise between the attractiveness of earning extra yield by extending maturities given the steep slope of the tax-exempt yield curve, and seeking to limit overall exposure to rising yields should the Treasury market sell off.

That being said, credit quality is perhaps an even more important aspect in the current environment. For credit-conscious investors not focused exclusively on a yield pickup, we recommend focusing on high-quality sectors likely to be best protected from credit and pricing volatility. Pre-refunded, essential-service revenue, general obligation, and special tax revenue bonds tend to outperform broader municipal-market benchmarks during periods of market stress. In deciding whether a specific bond meets their objectives, investors need to consider several factors beyond sector and credit quality including the bond’s yield, coupon, maturity, call provisions, and tax treatment. Following the sharp re-pricing that occurred within the municipal market, investors should give some consideration to the following:

- **Pre-refunded and escrowed-to-maturity (ETM)** – These bonds are supported by a pool of high-quality securities (usually US Treasury obligations) placed in an irrevocable escrow account to back the payment of both principal and interest. The bondholder therefore looks to the securities in the escrow, not the original issuer of the bonds, for repayment. Investors should ensure that they are comfortable with the permitted securities in the escrow.

- **Essential-purpose revenue bonds** – Backed by user fees for water, wastewater or municipal electric-distribution utilities, essential-service bonds can offer stability during periods of economic weakness. Revenues supporting these bonds are relatively insulated from economic conditions, as water and electricity usage tends to be stable through the cycle. We favor credits with broad, diversified service areas and strong rate-setting powers.

- **Special tax bonds** – These bonds may be backed by sales, income, gasoline, or other taxes. The highest-quality bonds in this sector have a broad tax base, give investors a first claim on the dedicated revenues, and have support from pledged receipts that provide a wide cushion of revenues in excess of debt-service requirements. The broad tax base and excess debt-service coverage protect investors from revenue volatility, so that even if tax revenues decline, there are ample funds to pay debt service.

- **General obligation (GO)** – GO bonds give holders a legally enforceable, full faith and credit pledge of repayment. Credit assessments of GO bonds focus on the breadth and quality of the tax base, the ability of the issuer to maintain balance between revenues and expenses, and the amount of debt and other fixed obligations that must be repaid. As the credit down-cycle persists, pressure on state and municipal budgets is likely to be reflected in GO ratings before those of the other three sectors we discussed. However, the long-term security of highly rated state and local governments remains strong.

Given the prospects for higher future marginal tax rates, reduced tax-exempt supply and our view that municipal credit quality remains fundamentally sound, we continue to recognize selected areas of the municipal market as an attractive sector for fixed-income investors. With the tax-exempt market having rallied sharply over the past year, some rebalancing within municipal portfolios is now warranted. However, risk-averse investors should still stick with the highly rated bonds in safer sectors, such as pre-refunded, essential-service revenue, general obligation, and special tax revenue bonds. While some maturity extension in the municipal market makes sense given the steepness of the curve, investors should focus on issues that range no longer than the 7- to 12-year maturity sector.

(3) Equities: Focus on dividend growth and a shift to quality

In the aftermath of two separate 50% declines in the S&P 500 within a decade, a strong re-adoption of the pervasive equity culture that the individual investor so quickly adopted during the 1990s (when the average annual return from equities was 16%) appears unlikely to materialize. Weak flows into US equity mutual funds over the past year support this view, but as the market and economic conditions continue to show signs of stability, lower-risk equity market segments, such as dividend-payers, should be attractive to investors looking for a lower-risk reintroduction to equities.

Looking at dividends at an aggregate level, we believe that the recipe for a meaningful increase in corporate payouts is taking shape. Currently, corporate cash balances are at multi-cycle highs – cash as a percentage of total assets stands at 11% – while dividend payout ratios (the percentage of earnings that are paid out as dividends) are low by historical standards. We believe that the combination of solid current free cash flow, strong non-financial corporate balance sheets, and persistent concerns regarding the veracity of the economic recovery will lead corporate managers to shy away from longer-term investments in both capital and labor and increase the return of capital to investors via both share buybacks and dividend increases.

Appealing aspects

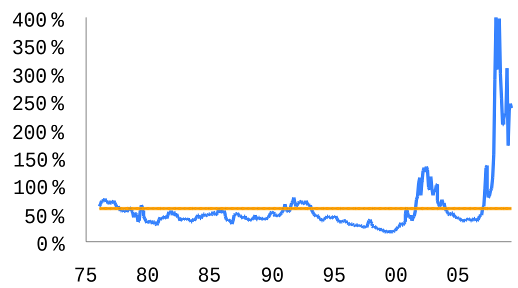
From the perspective of the individual investor, dividends appear attractive from three different vantage points:

- **Relative value** – The S&P 500 dividend yield currently stands at 2.2%, below its average since 1953 of 3.2%. But considering the currently low interest rate environment, dividends are more attractive than many alternatives. The S&P 500 dividend yield is now 60% of the yield of the 10-year Treasuries – in line with the historical average. Compared to shorter-duration segments of the Treasury curve, stocks' dividend yield is very attractive (see Fig. 8).

- **After-tax advantages** – Currently, the dividend income tax rate (for qualified dividend income) is 15%; interest income on bonds (other than tax-exempt municipal securities) is taxed as ordinary income, which for top earners currently is 35%. Keep in mind that the current marginal tax rates and tax rates on capital gains and dividend income are set to increase as of 1 January 2011 as the Jobs and Growth Tax Reconciliation Act of 2003 sunsets. Our UBS Office of Public Policy team believes that top earners will likely face pre-2001 income tax rates of 39.6% (from 35%) but that dividend income tax rates likely will be capped at 20%.

- **Demographic shifts** – The oldest of the baby boomer generation (those born between 1946 and 1964) turn 65 next year. Keep in mind that the Department of Health and Human Services cites that the average life expectancy for an individual who reaches 65 years of age is nearly 84 (see Fig. 9). While investing strategies will gradually shift from capital appreciation to income generation for these aging Americans, dividend-paying stocks should be utilized as an important growth component of portfolios in order to fund an increasingly longer retirement.

Fig. 8: S&P 500 Dividend Yield Relative to the 2-Year T-bond

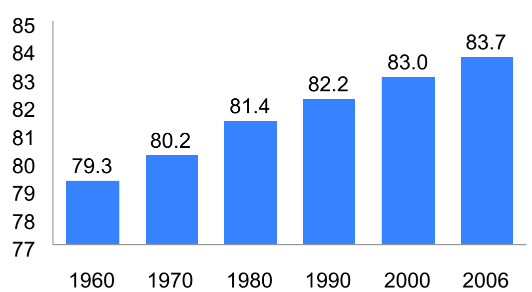


Source: Bloomberg, UBS WMR

Avoid the "high-yield trap" and focus on dividend growth

Too often, investors look for the highest-yielding stocks as "dividend plays" in order to satisfy current income needs. The problem with this overly simplistic strategy is that dividend yield, by definition, is the current dividend divided by the current price. So a high dividend yield may be the result of a falling stock price and fundamental problems with the company. Market dynamics adjust far faster than corporate board actions, so too often, investors buy a high-yielding stock and are ultimately disappointed that the "indicated yield" is not realized following a reduction in the dividend payment.

Fig. 9: Life Expectancy at Age 65



Source: National Center for Health Statistics and UBS WMR

Our preferred dividend strategy is to find companies that pay a solid (albeit not the highest) dividend yield and that have a strong track record of consistently growing their dividend over time at a healthy clip. Dividend growth is important since it not only showcases the ability of the current management, but provides some inflation protection for investors who, in essence, receive an income stream that grows over time. Companies that have been able to steadily increase dividends over the challenging last ten years also provide a strong indication to us that they posses a business model that is sustainable and able to generate cash flows throughout the business cycle. This helps to avoid those companies that pay high dividends during boom periods, only to cut their dividend when times become more challenging. One example of this more disciplined approach toward investing in lower-risk dividend growth stocks is our "Dividend Ruler Stocks" list.

We recommend that more risk-averse investors focus on dividend-paying stocks that provide a healthy mix of both growth and income in the current market environment. These stocks that can exhibit a clear commitment to growing dividends across cycles, and that can satisfy both investors' growth and income needs, should benefit from increased investor appetite for higher-quality dividend-paying stocks. We focus not just on dividend yield, but on dividend growth and sustainability as demonstrated by these companies's solid historical dividend-per-share growth "as straight as a ruler".

(4) Alternative investments: Still good diversifiers
The bear market of 2008 struck risk assets pretty much across the board, including alternative investments such as commodities and hedge funds. The expectation that such investments would help stabilize portfolios proved inaccurate under such a severe market dislocation and liquidity crisis. Yet while the crisis has shown the limitations of what one can expect from alternative investments, their inclusion in investors' portfolios remains essential to achieving long-term objectives. Consider what alternative investments could contribute as part of a reengagement strategy:

- **Commodities** – While every investor should recognize that most commodities involve a level of volatility comparable to equities, they remain one of the best available protections against rising inflation pressures. Since inflation impacts the funds needed in the future to achieve spending goals, a moderate allocation to commodities can help investors meet those objectives with greater certainty. At a time when inflation may be making a comeback a couple of years down the road, this is an important consideration.

- **Hedge Funds** – Hedge funds should not be viewed as a monolith. The hedge fund universe is composed of a broad range of strategies, some of which introduce a defensive element into portfolios, while others are at the more aggressive end of the risk spectrum. While it is true that their overall performance proved disappointing in 2008 (in the aggregate, hedge funds lost approximately 20%), returns varied significantly across different hedge fund styles. For instance, strategies that proved very resilient in 2008 included macro strategies (up 6%) CTAs (commodity trading advisors, up 12%) and equity market neutral strategies (down 1%). Understanding the different type of strategies being employed and using selective positions to supplement existing portfolio holdings can help dampen return volatility.

Portfolio strategies

In sum, alternative investments can be viewed as an interesting way to reengage in financial markets in combination with investment in traditional assets classes, such as stocks and bonds. Portfolios constructed with an mindset of harnessing their inflation-hedging properties (commodities) or their risk-reducing properties (selected hedge fund styles) can present risk and return properties with appeal to investors still struggling with the psychological aftershock of the crisis.

Conclusion

Although markets have rallied, the economy has begun to recover, and volatility has eased, individual investors remain understandably anxious about both the near-term and longer-term investment outlook. After having been conditioned to simply buy on the dips and hold on through the rough patches, market participants have fared poorly over the past decade and are now seeking less risky ways to reengage. Nevertheless, any strategy intended to generate incremental returns requires taking on incremental risk. We therefore advocate an approach that seeks to generate a higher portion of return in the form of current income while still allowing for below average exposure to market risk. This may not ease all the jitters of investors still shaken from the credit crisis, but it does offer risk-averse individuals a more sensible way for reengaging in the markets.

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Appendix

Alternative Investments

An investment in alternative investment funds (the "Funds") involves significant risks, including but not limited to, a loss of capital. There can be no assurance that the Funds' respective investment objectives will be achieved or that its investment program will be successful. In particular, limited diversification, the use of leverage, foreign currency fluctuations and the limited liquidity of the respective portfolio securities and other factors can, in certain circumstances, result in or contribute to significant losses to the Funds. The Funds charge administrative and management fees, which they will earn irrespective of profits, if any.

Appendix

Global Disclaimer