



Michael Jones, CFA, Chairman & Chief Investment Officer

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Managing Risk in a Range-Bound Market

Market volatility has accelerated sharply in 2010 compared to the steady market appreciation investors enjoyed in the second half of 2009. The victory by the Republicans in Massachusetts had the unforeseen consequence of turning President Obama into a populist business basher in his attempt to win back voters. The PIIGS (Portugal, Ireland, Italy, Greece, and Spain) now have credit spreads wider than the BRICS (Brazil, Russia, India, and China) and are causing the euro to weaken sharply, and thus the dollar to rally. Perhaps most importantly, after being united throughout 2009 in a single-minded effort to prevent another “Great Depression,” policymakers now confront a delicate balancing act between continuing to support the global economy and setting off an inflationary spiral. With central banks in Australia and India raising interest rates, the Chinese raising rates and restraining bank lending, and the Bank of England and the Federal Reserve approaching the end of their “quantitative easing” programs, global policy makers are clearly pulling back from an exclusive focus on supporting the global economy.

These events are all worrisome to investors but are not enough to derail the global economic and market recoveries, in our view. **Bottom line: if the global economy and earnings continue to grow into 2011, as we believe they will, then the cyclical bull is far from over.** However, the delicate balancing act confronting policy makers is likely to result in the S&P 500 oscillating in a trading range between 980 and 1300 as investors alternate between confidence and fear over the success of these balancing act efforts (see our *Outlook 2010* for further details). A range-bound market occasionally means testing the bottom end of that range, and we think we could potentially experience such a test in coming weeks. We have judged the risk of such a market move to be sufficiently high that we have taken a series of risk management steps in our portfolios. Importantly, these risk management moves do not reflect a loss of confidence in the bull market, but are merely an attempt to preserve capital and build additional cash reserves should we get a chance to deploy this cash at better prices in the coming weeks. **If the market signals that recession in 2011 is becoming a high probability (by falling significantly below our expected trading range) then we will be wrong and will have to become even more defensive.**

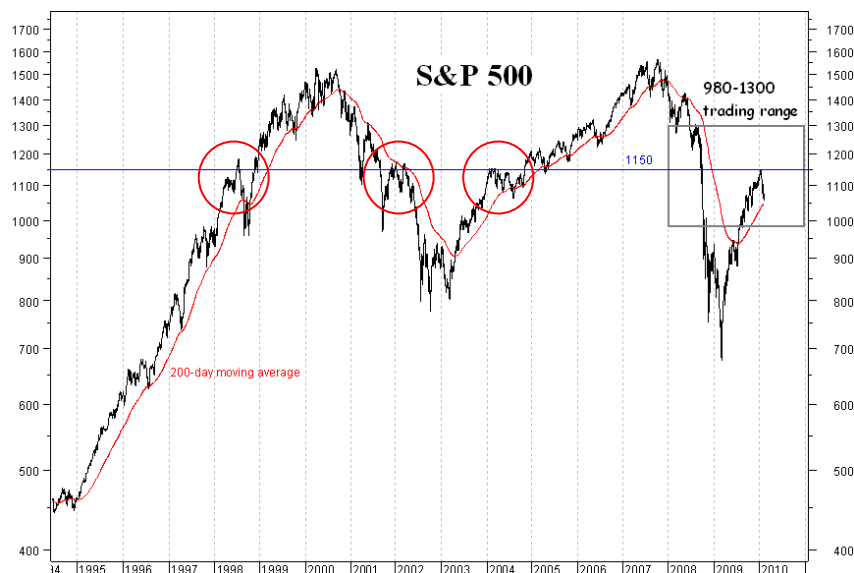
Strategic View

Strategically our Price MattersSM valuation framework indicates that risk assets such as stocks, commodities (with the exception of precious metals), and higher yielding, shorter maturity corporate bonds present the best opportunities for total returns as long as the global economy continues to grow, and we believe it will. We are very concerned about sovereign bonds, such as US Treasuries, in an environment in which so many countries have sought to reflate their economies through deficit-driven fiscal spending and monetary expansion. The risks to sovereign bonds appear particularly acute now that the central banks with the most aggressive reflationary strategies (the Bank of England and the US Federal Reserve) are winding down their “quantitative easing” purchases of government bonds. Among risk assets, we have a preference for global companies with strong balance sheets, global brands, and growing dividends; specifically high quality companies with global franchises that can grow their dividends, have pricing power, and could potentially benefit from those parts of the world that are seeing strong recoveries, most of whom are in the emerging world.

Tactical View

We believe that the current decline is only a correction, that the cyclical bull is not over, and that the market (as measured by the S&P 500) will ultimately go to new highs. However, unlike the relatively short and shallow corrections experienced in the latter half of 2009, this correction could last for several weeks -- perhaps even a few months. The market could fall enough to turn the shorter term moving averages lower, but we believe that the primary up-trend will remain intact (the solid line in the chart below). In terms of magnitude, we would expect a decline of 10% (plus or minus 2%) and that, at worst, the market should find support near the bottom of our 980 to 1050 support zone on the S&P 500.

If our support zone estimates are correct, then downside risks from here are limited to approximately 6% or 7%. With our recent portfolio changes we are attempting to do two things -- reduce overall risk in case our support zone estimates are wrong and reposition the portfolio for a market environment less dominated by the “reflation” trade. These risk management moves are also driven by our view that the mid-point of our expected trading range (about 1150 on the S&P) represents a market level that has been a temporary road block to further market appreciation several times over the past 15 years (indicated by the circles on the chart). Markets often require a couple of attempts before being able to punch through such historical resistance levels. During a similar period of increasing policy restraint in 2004, the market took nearly nine months and repeated efforts before it convincingly broke above 1150, and indeed the current correction began right at the troublesome 1150 level.



Source: RiverFront Investment Group. Current and historical analysis do not guarantee future results.

Responding to the current environment, we have reduced our tactical exposure to risk assets in recent weeks by around six percentage points in all of our asset allocation portfolios, bringing them in line with our strategic benchmarks. We have also raised quality and lowered exposure to non-dollar assets, such as European equities and emerging markets. When we judge that the correction is over, we anticipate reinvesting the money but, given our assessment that the euro is both overvalued and under tremendous financial stress due to the plight of the PIIGS, we anticipate remaining underweight the broad European market for the foreseeable future.

Equities and Fixed Income Views

Equity View

- **We think attractive investment opportunities in stocks remain abundant.** Numerous high quality companies with low levels of debt, high levels of cash, and a history of consistent 15% earnings growth can be purchased for as little as 11x 2010 EPS (earnings per share) estimates, while the overall market is trading at more than 15x. These companies are not only meeting analyst expectations, but surpassing them as the economy exits the Recession, and they should not be trading at these kind of discounts to the market, in our view.
- **Based on the fourth-quarter earnings reporting season, we believe that the worst is behind us.** We believe the fourth quarter marked the turn in fundamentals for many companies. Those in cyclical industries, such as Technology, Industrials, and Consumer Discretionary experienced revenue growth and some margin expansion; Financials experienced improvements in the loan books and capital positions; and companies in the Healthcare sector saw a significant easing of political pressure.
- **No rising tide to lift all boats.** Unlike 2009, when almost all stocks benefited, we anticipate 2010 returns to be more selective. Companies that can meet analyst expectations will likely continue to rise, while those that disappoint are likely to retrace a portion of their 2009 gains. The quality bias in our portfolios exists for this reason, and we expect it to pay off in 2010.

Fixed Income View

- **Corporate health continues to improve.** Corporate earnings have rebounded, and the credit markets remain receptive to even the lowest quality issuers. As a result, the high-yield default rate is expected to fall sharply this year -- from 13% to a more normal 5%.
- **In contrast, sovereign credit quality continues to deteriorate.** The fiscal condition of developed economies remains strained by high unemployment and the costs from bailouts and stimulus packages. The turmoil in the PIIGS will likely increase the volatility of all risk assets, but especially emerging market sovereign debt.
- **Treasuries could temporarily benefit from “flight to quality” trades, but over the longer term we believe that rates are headed higher.** For the past year, the Federal Reserve has been purchasing approximately \$100 billion per month in longer term government bonds (primarily mortgage backed securities). The Fed has announced that it will cease these purchases in March, and we believe that in order to attract enough new buyers to replace these Fed purchases, interest rates are likely going to have to rise.

Risk Management -- Adapting to a Potential Correction

Our investment process is built upon both Value (what’s cheap) and Momentum (what’s working). Although many risk assets remain attractively priced and offer long-term value, in our view, our Momentum disciplines have prompted several proactive tactical steps to reduce risk in the face of a near-term deteriorating technical momentum picture. Since late January, we have:

- Raised 3%-5% additional cash, bringing total cash in our portfolios to approximately 10%
- Reduced international equities by 400 basis points (“bps” = 1/100th of 1%) in Europe and emerging markets
- Reduced exposure to emerging market debt by 200-300 bps
- Reduced commodity exposure by 400 bps
- Reduced the interest rate risk of our bond portfolio by shortening duration
- Increased high-quality large-cap equity exposure by 500-600 bps

These risk management moves in no way reflect reduced confidence in the longer term prospects for the market, and we anticipate redeploying the cash we’ve raised as market conditions improve.

*Michael Jones, Chairman and Chief Investment Officer • 804-549-4801 • mjones@riverfrontig.com
www.riverfrontig.com*

Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

Past performance is no guarantee of future results. Dividends are not guaranteed and are subject to change or elimination. The following risks should be considered when discussing investment options with your clients: (1) Investments in **international and emerging markets securities** include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. (2) Buying **commodities** allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual’s portfolio. (3) **High-yield securities** are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

RiverFront’s Price MattersSM discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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