

Fourth Quarter 2009
Investment Commentary



A combination of positive economic growth signals and exceptionally low interest rates spurred a strong rebound in global equities in 2009, ending a very volatile decade for stocks. Foreign stocks, particularly emerging markets, outperformed US stocks for the year. The rally extended to bonds as Treasury yields remained low and relatively stable and credit spreads normalized. The average diversified pension equity portfolio hasn't fully recovered, returning 20% in 2009 after a 22% loss in 2008. Portfolios that retained a quarterly portfolio rebalancing discipline over the last 2 years outperformed those that didn't by over 2% annualized.

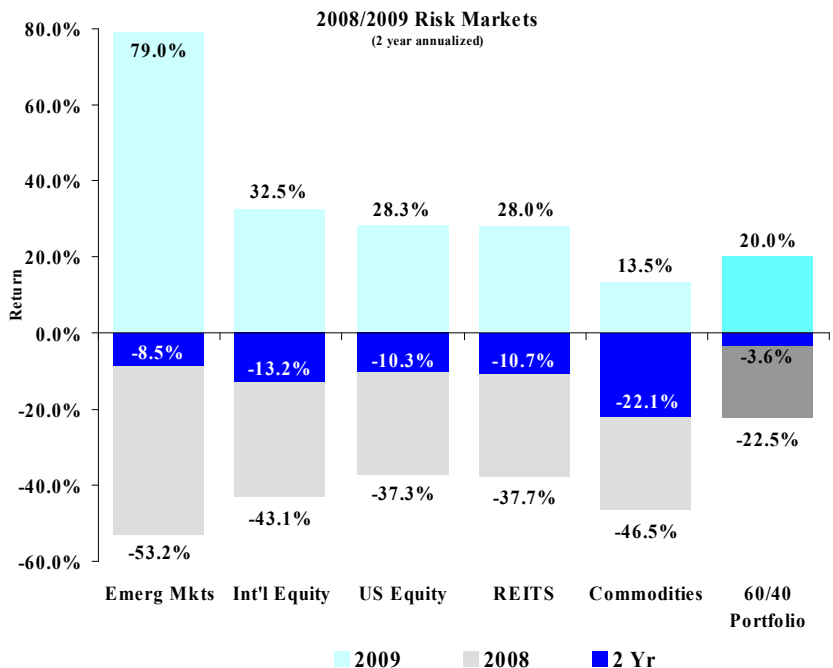
Record Stimulus Yields Risk Rally

Equity investors relied on a mosaic of improving economic data to bid up global equity prices after the stock market bottomed out in March. By year end the MSCI World Index had gained 35.4%, recovering from an -11% loss in the first quarter. Forecasts showed that developed economies would grow at 2% – 3% in 2010 and future years. While low by historical standards, these growth levels looked quite attractive compared to the catastrophic scenarios priced into the markets early in the year. Uncertainty about the pace and duration of the recovery added some volatility to the stock rally, though monthly returns only went negative four times in 2009, twice in the first quarter.

The S&P 500 returned 26.5% in 2009, 6% during the 4th quarter. Growth stocks trumped value stocks through the year, powered by the technology sector. The Russell 300 growth index returned 37% in 2009 vs. the Russell 3000 value index's 20% return. Technology (60%) followed by Materials (45%) and Consumer Discretionary (39%) lead S&P returns. Geographic revenue sources and expected earnings growth rates correlated to returns in 2009. The technology sector earns 51% of its revenue abroad followed by materials which derives 42% of its revenues internationally. In the worst year ever for dividend cuts, Financials (15%), Utilities (6.8%) and Telecoms (2.6%) lagged the market. Market capitalization had less of an impact than investing style as the Russell 2000 small capitalization index finished the year with a 27% return and the Russell Top 200 large capitalization index posted a 24% return. Mid caps dominated

the capitalization categories generating a 40% return per the Russell Mid cap index. Across the universe of investment funds we monitor, benchmark relative performance tended to be the inverse of 2008 as higher beta funds outperformed and more conservative funds lagged.

Developed international markets outperformed the US, but much of the performance gap was due to a 17% decline in the value of the US dollar since March. Structural concerns about US policies and an active carry trade resulted in exchange rate appreciation across many currencies. A declining dollar makes assets priced in foreign currencies more valuable when translated back into the US. The MSCI EAFE was up 32% in 2009 (21% in local currency). International

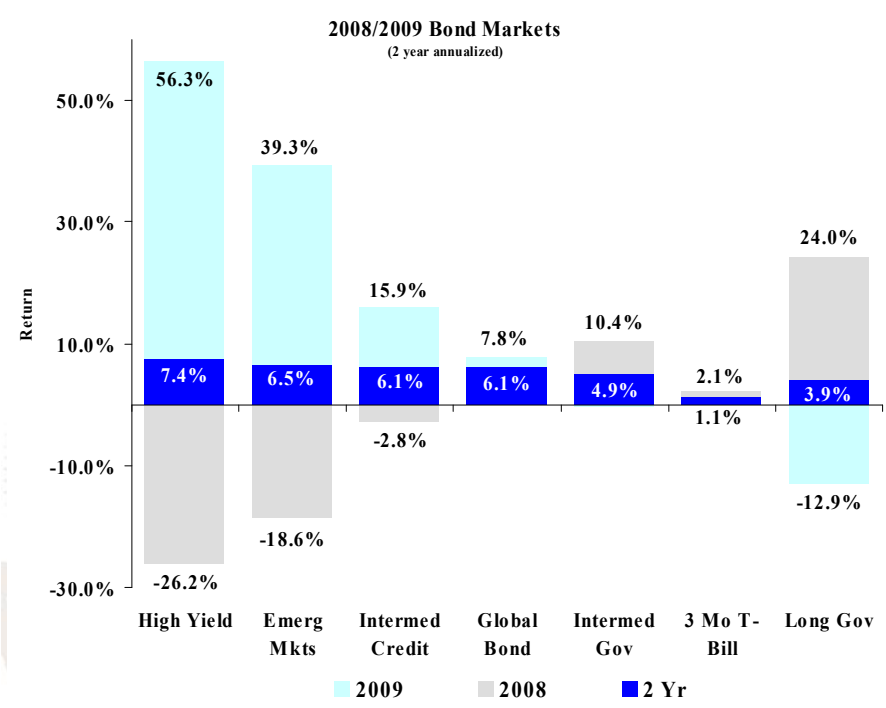


emerging markets attracted lots of money in 2009 based on their higher expected growth rates and commodity based economies. The MSCI Emerging Market Index rose 79% in dollar terms in 2009, (59% in local currency). Despite its soaring returns in 2009, emerging markets lost substantial value in 2008, keeping its 2 year annualized return (-8.5%) in line with some domestic indices such as the Dow Jones Average(-8.6%).

Investor’s perception of the real estate market seems to have improved as the NAREIT index added 28% in 2009. Yet, real estate fundamentals remain weak. Residential real estate markets may bottom first while commercial markets can only recover after the credit conditions and consumer spending improves. Commodities did reasonably well in 2009, though return dispersion was high. The Goldman Sachs Commodity Index added 13.5% in 2009 after losing

-46.5% in 2008. Gold, long perceived as an inflation hedge and safe haven currency added 23% while oil added 7%. Despite its momentum, we remain cautious of the strategic portfolio value of this “asset class”, noting its high correlation to other risk assets in a down market and its reliance on speculative price action rather than the value of compound investing for returns.

Bond Returns Reward Risk



The Barclays US Aggregate Bond Index returned a comfortable 5.9% in 2008. This return doesn’t reflect the wide performance disparities among bond sectors driven by unique stimulus and demand dynamics throughout the year. Treasuries were challenged but credit investors were rewarded as spreads normalized subsequent to first quarter. Foreign bonds outperformed as the dollar fell through the year.

Risk free rates approached zero at the short end of the curve and rose through the longer maturities, especially in the 4th quarter. T-Bills returned .21% while the Barclays Intermediate US Government and US Treasury Long

Index lost -.3% and -12.9%, respectively in 2009. Losses might have been worse had yields not been depressed by; banks demand for government securities in the face of low loan demand, retail demand for bond funds as a lower risk alternative to stocks or a higher yield alternative to money market funds, sovereign fund demand to support their currency management programs and central bank purchases. Treasury Inflation Protected Securities benefited from a deflationary to an inflationary paradigm shift, adding 11.4% for the year per the Barclays US TIPS index. The 10-year break-even inflation rate at year end stood at around 2%, below the long term inflation average.

Meanwhile, by any measure, it was an extraordinary year for high yield debt. The Merrill Lynch High

Yield Index added 56.3% in 2009. Investment grade credit added 15.9% according to the Barclays US Intermediate Credit Index as credit spreads receded. The Markit CDX NAIG, which tracks the cost of credit default insurance, fell to levels last seen in the beginning of 2008. The rally in credit in 2009 follows the stock markets bet that the economy will continue to recover.

The longer term effects of the government policies used to rescue the global economy in 2009 remain unknown. We do know that the current policies are unsustainable. The low rate, cheap credit policies designed to protect the financial sector from collapse, spur bank lending and revive the real economy, so far have funded a global risk trade. Banks and investors are using cheap money to finance higher yielding, higher returning assets. Until policies change, positive price momentum can prevail...after all, "as long as the music is playing", many investors "got to get up and dance". 2010 market results will be substantially impacted by both expected and actual fiscal and monetary policies. In the face of uncertainty, investors can only evaluate their

long term strategies to be sure they are adequately diversified and reasonably situated for a range of outcomes in 2010 and beyond.

The Value of TIPS

There is a growing sense that the monetary and fiscal policies required to exit the great recession of 2008/2009 are laying the groundwork for future inflation. This sentiment alone can have an impact on asset returns and investor behavior, regardless of the future course of inflation. In light of that, we briefly examine the case for providing exposure to Treasury Inflation Protected Securities or "TIPS" in both pension plans and 401(k) plans.

TIPS provide investors protection against inflation while protecting against deflation. They are government issued bonds designed to provide a certain pre-tax real return when held to maturity. TIPS pay interest twice a year, at a fixed rate. The rate is applied to a principal value which is adjusted for accrued CPI inflation. Interest payments rise with inflation and fall with deflation. When a TIPS matures, investors are paid the greater of its adjusted principal or original principal, providing a hedge against both inflation and deflation.

The yield on a conventional Treasury bond that pays a fixed coupon must also include an expected inflation component to compensate the investor for future inflation. Its yield therefore includes a real rate of interest and an expected inflation component. With TIPS, the coupons and principal adjust relative to CPI so its yield is simply the real interest rate. The difference between the two yields reflects, among other things, expected inflation.

TIPS in Pension Plans

While the primary role of fixed income in many non ALM pension investment programs is to serve as a volatility hedge for stocks, it can also be constructed to offer inflation protection. The value of TIPS in a fixed income allocation, specifically as an inflation hedge, will be dependent on the nature of the plan's liabilities.

Since the typical defined benefit plan has a set of liabilities that acts like a mix of nominal (retirees, term vested or frozen actives) and inflation linked (benefit accruing actives or inflation indexed retiree benefits) bonds, inflation can have varying impacts. Inflation protection may be less critical for pension plans that are mature, are not duration matching their liabilities and don't have benefits that are linked to cost of living. Mature plans with a lower proportion of active participants may not be as exposed to salary inflation and might even benefit from the impact that inflation can have on devaluing plan liabilities. If a plan's liabilities are not indexed to inflation, it benefits by paying nominal liabilities in inflated assets. Deflation represents a more considerable risk for these plans, so inflation protection may not be a primary

objective.

Pension plans with a "COLA" liability based on their benefit formula can be negatively impacted by inflation. They would be natural holders of TIPS, along with other investors who want to match assets and liabilities in real terms. Financial assets, like nominal bonds, typically do poorly during periods of inflation, so a mix of TIPS and other inflation hedging assets such as commodities might be a good fit for these plans.

TIPS can also be used in pension plan portfolios as a diversifier since they behave differently than traditional fixed income securities in various market environments. Recent changes in pension accounting rules and the funding calculations of the Pension Protection Act of 2006 add to the diversification value of TIPS as either a strategic or tactical asset class.

TIPS in 401(k) Plans

401(k) plan sponsors have traditionally emphasized long term growth investments such as equity funds for their retirement investors. Equity tends to grow faster than bonds and has outpaced inflation in the long run. Traditional retirement portfolio planning suggests that as plan participants approach retirement they should increase their allocation to bonds to avoid the volatility of equity and other inflation hedging assets such as real estate or commodities. However, as their bond exposure grows, inflation replaces volatility as a primary risk. At a modest 3% inflation rate, prices can double over the life expectancy of the average retiree.

Plan participants often have only a few bond fund alternatives. The majority of 401(k) plans offer either a stable value fund or a money market fund and maybe a market value intermediate bond fund or two. None of these alternatives may fully hedge inflation. Nominal bonds can perform poorly in the immediate wake of an inflation spike as yields increase. As yields and prices stabilize, nominal bond returns can ultimately predominate price declines, but the timing of this catch-up depends on the nature of the bond fund. Money market returns are likely to increase after an inflation spike, but their response is based on monetary policy and may have limitations. Stable value funds can adjust to inflation, perhaps better than money market funds, though the extent of the lag and the degree of their participation depends on their portfolio structure, duration and cash flows.

TIPS fully hedge inflation as measured by CPI and therefore could be a valuable addition for some investors in a 401(k) plan. There are also certain tax advantages to holding TIPS in a tax deferred account. Investors receive full inflation protection if TIPS are held in a tax deferred 401(k). According to Hewitt research, specialty bond funds, including TIPS funds, increased by 10% in 2009. Vanguard's 2009 retirement plan survey data indicated 19% of its defined contribution plans offer a TIPS funds.

While TIPS are well suited for a role as an inflation hedge or fixed income portfolio diversifier in a 401(k) plan, other aspects should be considered in determining their suitability for a specific plan. While TIPS are relatively risk-free in the long run, they can be quite volatile in the short run. Naïve investors might assume that the inflation adjustment is the primary source of total returns for TIPS. However, a change in real interest rates, positively correlated with investors' inflation expectations, has historically had a more significant impact on TIPS returns. TIPS can generate losses, even with rising inflation expectations, should real rates be rising faster or should heavy demand for TIPS drive yields down. Shorter maturity TIPS can reduce interest rate risk while maintaining inflation protection.

If TIPS notes are not held to maturity, investors lose their fixed real rate of return. Fluctuations in the yield on newly issued TIPS result in changes in the prices of existing securities, exposing investors to capital gains or losses. This market price exposure means that holding TIPS for short

periods of time negates their inflation hedging capabilities and exposes investors to almost a similar level of price risk as nominal Treasuries.

Most 401(k) plans that offer TIPS use a TIPS fund rather than individual TIPS. TIPS funds have some advantages but do not allow investors to hedge date certain future liabilities. TIPS funds can be thought of as a rolling ladder of individual TIPS which have a specific duration. This structure exposes investors to some level of realized gains and losses as they draw down their investment through retirement. The financial impact of these hedging mismatches will be determined by the dollar weighted inflation component of pre retirement accumulations vs. post retirement distributions. For long term regularly scheduled accumulations and distributions, these impacts could theoretically average out.

TIPS investments can provide a conservative way for 401(k) plan participants to diversify their fixed income portfolios and hedge a slower growth, inflationary environment. However, like many fixed income sectors, they are somewhat complex and less well understood by participants, raising the potential for inappropriate expectation and utilization. Plan sponsors should consider a number of factors when determining whether a TIPS investment would be a suitable alternative for their plans:

- Demographic distribution of plan participants
- Range and characteristics of existing total plan and fixed income alternatives
- Retention of retirement accounts by post retirees
- Associated defined benefit pension plan benefits
- Ability to educate/inform participants about TIPS
- Utilization of advice facilities

Sincerely,

Timothy C. Burns, CFA

Hunter Capital Advisors, Inc



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Fiduciary Focus

