

Rochdale

Investment Insight

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2010 Market and Economic Outlook: Restructuring and Recovering in the wake of the Great Recession



A conversation with Garrett R. D'Alessandro, CFA, CAIA, AIF®,
Chief Executive Officer & President

Highlights:

- For 2010 we're giving a 75% chance of positive growth for all four quarters. We're also giving a 15% to 20% chance for a double-dip recession and the implications for that will not be known until the monetary and fiscal stimulus starts to fade.
- In order to dynamically manage the risk of a portfolio, you have to have a process through which you identify rising volatility. You have to understand that the correlations across stocks and across asset classes will change dramatically during periods of rising volatility and that causes the representations that are made to clients, through the normal Ibbotson and Callan type of asset plans, to understate in a material way the risks that are really present.
- If our macroeconomic outlook indicates growth and we believe corporate profits are growing on a long-term basis, then movements in the stock market do not dissuade us from being fully invested. In the high-yield category, at the end of the day, we believe that asset class will provide an additional return to investment grade fixed income. Those credits are worthy of holding in a growing economy. If we think that we're going to go into a recession, then allocation to high-yield would be much less or even zero within our fixed income space.

The following discussion is moderated by Derek Roy, AIF®, Vice President – Investment Consulting, of Rochdale Investment Management. The below is a transcription from Rochdale's January 15, 2010 Advisor Forum Conference Call.

Q: Last April it seems that Rochdale made the correct call that the recovery would arrive sometime later in the year. Now there seems to be general agreement that the global recession ended around the third quarter of 2009 but there's a wide range of views about the strength and sustainability of this upturn. You know we hear terms like V-shaped recovery or double-dip recessions, etc. So Garrett, how would you describe the recovery so far and how do you expect this progression to proceed?

A: In terms of 2010, we expect the first half will be somewhat stronger than the second half. The principal reasons for that are the continuation of the stimulus, the bulk of which will occur in the first half of 2010, and the lagged effects of monetary stimulus which will continue to help as well in the first half. It's unclear at the present time, but at some point, probably around the third quarter, some of that monetary stimulus might begin to lessen. The plan is for no additional stimulus beyond the first half, or not a material amount, but I think that's a determination that will be made each quarter by the Obama administration, depending upon the progress of job creation and things like that.

So for the year, we're giving a 75% chance of positive growth for all four quarters. We're also giving a 15% to 20% chance for a double-dip recession and the implications for that will not be known until the monetary and fiscal stimulus starts to fade. I want to make a key insight. If someone were to ask me if I had one wish for the economy in 2010, I would have a very easy answer. I would wish for the facilitation of credit to resume and trend back towards normalcy. If we see continued signs that the banks, credit card companies, capital leasing companies, and all other forms of credit provision are gradually and slowly moving in a positive way, then we will have greater confidence that when the stimulus from monetary fiscal policy is withdrawn, that the normal organic behavior of a capitalistic economy, which is for growth, will occur. If we are a credit-based economy and we have a resumption towards normalcy in the credit markets, then we have 75% to 80% confidence we're going to grow all year. And if I were to put a number on growth, I think we're maybe in the 3% zone for the first half of the year and then we're probably in the 2% to 2.5% zone for the second half of the year.

Q: Keeping on this theme of what a difference a year makes, in the first quarter of 2009 it really seemed very possible that a systemic collapse of the system was at hand. Now, a year later, it looks clear that the response of the Federal Reserve has more or less worked, at least in preventing the crisis from morphing into a full-blown depression or a deflationary spiral. However, the implications of what the Fed has done, you know skyrocketing budget deficits and monetary creation, is causing many folks to be concerned. So what would your thoughts be on the Central Bank's eventual exit from all of this policy intervention and what the effects might be on the economy and the markets as a whole?

A: My response is that it will take many years to unwind what took many years to create. I also feel the same way about the job market. We are not going to rectify and achieve a complete equilibrium in terms of the natural rate of economic growth on a sustainable basis until all of the material imbalances, such as the Fed's \$2 trillion balance sheet, unwind. I think the relevant point here is the Fed, if they're true to their word, has given every indication that they will not undertake an exit strategy, which has many tactics to it beyond just raising interest rates, until they believe and have confidence that the economy is on a sustainable enough trajectory to continue to grow absent the effects of the monetary stimulus across many components. So if they prematurely withdraw their stimulus, the risks of a double-dip recession might rise. If they wait too long, the prospects for inflation might cause the long end of the yield curve to rise, which would truncate the ability of people who borrow at the long end to access capital at an effective cost. And we know the history of the Fed. If I use a diving analogy, when a diver jumps off of the high dive they very rarely get eight, nines, or tens from the judges. They usually get threes and fours. They don't have a good track record in timing the exit. So we're not confident that they're going to get the timing right. Therefore, we are on full alert to tracking their behavior and we are going to modify not only our economic outlook but our portfolio strategy depending upon what they do.

Q: Garrett, there's a more specific follow-up to that question. I mean with the monetary and the fiscal stimulus, we've just flooded the system. Would you mind talking a minute about the possible consequences of inflation due to all the stimulus?

A: I get that question all the time. It's important to understand that printing money alone does not create excess money in the economy. There's the means to get it into the economy and the conduit typically is the banking industry. The velocity at which it gets into the economy is the key observation here. Right now, if you were to take the money that the Fed

printed, more than half of it is still sitting in the vault of the banking system. In our opinion, it is not accurate to say that because the Fed has printed money we will have inflation. The banks currently are not putting that money back into the economy and it has resulted in the credit card companies cutting credit lines, banks not renewing credit lines, and banks not making normal business loans. Consequently, since the banks are not putting all that money out into the economy you will not have the threat of inflation. The Fed, more than anyone, is fully aware that all the money they printed has the potential to cause inflation. I believe the first phase of their exit strategy will be to corral or quarantine buckets of those billions of dollars in ways that can not go back into the economy with high velocity. Therefore, for this year, we do not see inflation being a concern for our investment strategy and we are not of the view that inflation will cause implications for our investing asset allocation decisions.

Q: Let's turn our attention to the consumer for a second. The consumer represents 70% of the U.S. economy and you've been saying for some time now that the consumer is in a retrenching mode; increasing their savings, decreasing their spending, basically having to finally pay the bill for the last decade of credit-driven spending. So, what would the implications of lower consumer spending, higher consumer savings have on the job market and specifically any sort of job recovery in 2010?

A: Let's go through the two key points here. In a normal recovery from a deep recession, the economy would grow 5%, 6% for 12 to 24 months. So the baseline for comparison is growth at, say, 5% or 6% for one to two years. We do not project a normal recovery of that sort for this phase. So the answer to the question is that the bill is coming due in terms of the consumer having to reduce their indebtedness and the job market being substantially weak. The recovery is probably going to be 50% as vibrant as it would otherwise be, and I think that's another nuance that a lot of people are not taking into account. These weaknesses, a great deal of unemployed people, the bills coming due, are being addressed rather aggressively. We recently put out a piece where we indicated that the write-offs of the levels of indebtedness, the repayments of indebtedness, that's escalating at a very rapid pace and we've actually seen the contraction of consumer debt for the first time in decades. So we believe people are really getting after the problem and paying the bills as quickly as they can afford to and bringing the liabilities on their balance sheets down. Overall, we are a little more optimistic than I think the pessimists tend to be. The 85% to 90% of people that have a full-time job, they are getting a reasonable enough wage increase to grow their spending, because most people increase their spending equivalent with their wage increases, 2% or 3%. And that's why we're saying the economy is going to be slow-growing in that 2% range rather than the 4%, 5%, and 6% range in a normal recovery.

Q: You know it's no secret that the credit crisis began with the collapse of the housing bubble, but it's funny how when you look around today, the whole real estate market, at least the headlines and the news stories, seems to have taken a little bit of a backseat in the media. What do you think is in store for the real estate market in general in 2010? More importantly, how will it impact the economic outlook and the investment decisions moving forward?

A: In our forecast it's embedded in our rollout that the banks will have extensive losses still on residential foreclosures and defaults all throughout the year. During the first half of this year several real estate markets will reach a stability level in terms of price declines, they will stop going down, and by the second half of the year, an additional set of metropolitan areas will reach price stability. Of course, some of the worst areas in Arizona, Nevada, California, and Florida will continue experiencing price declines throughout 2010, although not likely exceeding another 10 percent. The point is, since real estate is regional, we're going to have a rolling real estate stabilization process throughout 2010. This is important because as banks increasingly know the full extent of the losses, foreclosures, and the write-offs on residential, they will increasingly be able to create the reserves to handle those losses and foreclosures with the very strong profits that they are creating due to the fact that the Fed is handing them money at essentially no cost.

So in summary, the consumer, the state of mind of the consumer will on a rolling-out basis across the country become more positive that the value of their home has stopped going down, combined with our expectation that new jobs will be created in the first couple months of 2010, and those two headlines are worth more than their weight in gold in this respect. As a country, we are consumer-driven 70% and we think that percentage is going to trend down over the next several years to 66%. However, as the consumer becomes more comfortable that they have a job and/or they're going to get a job and that the value of their house has stopped going down; their desire to spend will increase. And more than anything,

that matters. If the banks start to get back to a normal facilitation of credit, then we have confidence that the second half of this year and 2011 will see modest or moderate economic growth.

Q: Great. Well, let's turn our attention from some of your economic thoughts to maybe more specifically some portfolio strategy thoughts. You know the equity markets have certainly exploded off of the bottom last March in responding to the brightening outlook and in many cases portending a better outlook, but what surprised you the most about this significant rally throughout 2009?

A: We made a good observation about the economic outlook in April. That was based upon our multifactor proprietary recession monitor and we are very happy with the thoroughness and outcome of the homework we did. We then applied that conclusion to our asset allocation in our portfolio implementation. In that regard, if we were to give ourselves a grade it would maybe be a C+ or B-. The reason for that would be because, although we decided that we wanted to get back into the equity market starting in April, we wanted to average in over the next couple of months. In hindsight, the best strategy would have been to get a 100% invested on April 1st, but we did not do that. So, while our performance was still quite good, it could have been better. However, when I think about the thing that most surprised me in 2009, it was certainly the rapidity at which that market recovered over the six or seven months following the March bottom.

The reaction on the downside was as we had indicated. In fact, the correction was so excessive or so extreme that it has fundamentally altered our belief that normal asset allocation models using normal covariance matrices, making normal correlation assessments across asset classes, is a bona fide way to construct the portfolios. Now, when we build portfolios we take into account these new normal characteristics of increasing correlations across asset classes, the failure of diversification on many levels and the skewness of the equity markets. So, all of those things are now being included and accounted for in our portfolio management this year.

Q: Garrett, I want to come back to the asset allocation discussion in just a minute. Before we change that topic, I know in my travels and speaking with financial advisors and clients, many people are concerned that the economic foundation upon which this stock market rally has been built is very shaky. The million-dollar question is with the easier gains in the market behind us, how much more upside do you see in the stock market over the next couple of years?

A: I've been asked this for just about a quarter of a century and I have absolutely learned one thing, it does not matter how fast a stock has risen or how fast a stock market has risen. What truly matters is if the present valuation of the stock or if the stock market looking forward is attractive. Stocks that have risen 60% or 80%, depending upon the market, do not have a significant influence for long-term investors, which is what we are. We look at the current valuation of the S&P 500 and we think two things; we think that in 2010 the S&P will earn about \$78 and we have a \$2 range around that and we think that in 2011, we're at about \$90. So when you take \$90 and you multiply that by 15 times you come up with something in the 1300-range for the S&P 500. That's about 200 points more than the current S&P 500 level and that gives you a mid-to-high-teens total return over a two year period.

I have no idea what the market's going to do on a month-to-month, day-to-day, and quarter-to-quarter basis. However, if the probabilities that we've assigned to the economic outlook, 75% to 80% of modest growth, does occur, we believe that the operating efficiency of the S&P 500 companies in combination with the productivity and profitability of the companies, plus pulling in that growth from foreign markets, will generate double digit S&P profit growth for two years on average. The market now is trading at 14 or 15 times 2011 forward earnings. Even if you give up a point in the multiple, the stock market has the potential to generate 8% to 10% average annual return. When we look out we are generally speaking. It might do zero this year and 20% in 2011, it might do 15 and 5. Although, we think over a 2 year period that the stock market is going to earn about or a little bit less than its long-term average, we want to be fully invested at this point.

Q: What about emerging markets, Garrett? We've just gone through a decade of where emerging economies largely outperformed their G7 counterparts. Do you foresee that trend continuing?

A: We apply the same type of disciplined analysis and when lumping all emerging markets together, we don't see material overvaluations. While the emerging markets' valuations have certainly risen and they're now reaching equilibrium with

U.S. markets, which is a little bit of a risk exposure, we believe that they will provide 10% to 12% type of returns rather than the 8% to 10% for U.S. markets. So we like those markets and we're overweight those markets.

Just a side comment on China, we do not think China is in a bubble. If you're driving down the Autobahn, although that's not in China, at a 105 mph and you tap on the breaks because you want to slow down to 90 mph, I wouldn't call that bad. I would call that sensible. So the press is making a much bigger deal than appropriate over the Chinese government slowly putting interest rates up or making banks loan a little bit less. You know they're kind of tapping down the speed but they're still going to grow 7%, 8%, 9%.

Q: Let's turn our attention to what's on everybody's mind, asset allocations in this new normal environment. As a function of controlling risk, not market timing, we raised cash in a lot of clients' portfolios from late 2007 thru 2008. Last year, in anticipation of a sustained, albeit modest, economic recovery, Rochdale reduced the cash positions in all client portfolios to near zero and built out our equity portfolios towards the higher end of each asset class range. How has the 08/09 bear market impacted your view on asset allocation and investing as a whole? What is your current view on Buy & Hold as an investment strategy? I know I get questions a lot about buy-and-hold investing or a lot of the passive rebalancing type of strategies. What's your viewpoint on asset allocation as we navigate the future?

A: The notion of diversification being a principle or obligation of money managers and financial advisors is something that we have spent and continue to spend a lot of time on. It's our conclusion that the diversification that the clients believe exists in their portfolio does not actually exist. The notion of phase-locking, which in simple terms is the coordinated move of asset classes and other securities that are not supposed to be tightly coordinated or correlated, has happened in 2002, 2008, and we believe will continue to happen. So philosophically we like the notion of buy-and-hold investing, but we're not committed to a passive buy-and-hold strategy because it would violate the requirements that we have for diversifying our clients' portfolios during bad periods.

That leads us to what we say is DRM, dynamic risk management. In order to dynamically manage the risk of a portfolio you have to have a process through which you identify rising volatility. You have to understand that the correlations across stocks and across asset classes will change dramatically during periods of rising volatility and that causes the representations that are made to clients, through the normal Ibbotson and Callan type of asset plans, to understate in a material way the risks that are really present. We had modeled these distributions recently and they are not normal. One of the principal assumptions of modern portfolio theory is that it's a normally-distributed market. That's not been the case over the two bear markets and we do not think it will be in the future. As a result, we've raised our level of effort to get each client to develop a personalized risk budget. That takes more time and more work because of everything that I have previously mentioned. We go through not just normal standard deviation volatility, but we go to two-standards and three-standards, excessive and extreme, and we also communicate that we are not inflexible (i.e., we are not wedded to buy-and-hold if it causes clients risk budgets to be exceeded.)

A final point here. We've implemented hedged alternative strategies for some portfolios, which brings diversification and creates lower correlation across asset class holdings, and we're advocating 10% to 20% for all of our high net worth clients. It could come from either the fixed income side or the equity side.

Q: Garrett, studies show that 90% of a portfolio's return is derived from asset allocation. What specific investment areas are you focusing on as it relates to asset allocation and where are we investing clients' money right now?

A: In a global context, for a high-net-worth-growth investor where they would have 70% equity, give or take, and 20% or 30% fixed income, we are overweight international and high dividend income equities. We are neutral to underweight U.S. equities. We are also overweight high-yield and leveraged bank loans, and we're overweight low-volatility alternative strategies.

Q: Let me expound upon a couple of those. High-yield, I mentioned it earlier and I get questions about that all the time. Some people are saying that the window to own high-yield has come and gone. You've had a tremendous

rally and with many cases high-yield instruments acting just like their common equity counterparts. What are your expectations for high-yield as an asset class from today, moving forward?

A: High-yield is different than senior secured bank loans and I think that is a very important distinction. When we manage a client's portfolio and we talk about high-yield, we have a bilateral approach. We have both senior secured bank loans and high-yield, and we have the flexibility to include either or both of those within our portfolio allocation.

To directly answer the question on high-yield, let me tell a basic story. Currently, the banks are still not really lending normally. They're still licking their wounds for all of the losses that they've taken and still have to take all of 2010. There's also a limited amount of securitization going on. So, would you like to be a banker today when a viable business walks in the door that has a good credit history and says I need a loan to do a plant expansion or I need a loan to do some business? You certainly would like to be a banker because the banking industry is going to be able to price the marginal borrower at a full rate of return, or what we would call a spread over the investment grade that is attractive. I'm not talking about the S&P 500 companies, they're not high-yields, they are a separate category.

Therefore, just because high-yield returned 40%, 50% or thereabouts last year, it's not our view that the advantage high-yield fixed income has over investment grade has disappeared. Currently, total return for high-yield looks about 7% or 8% and total return for investment grade, about 5%. If you're going to get 2.5 points more over a denominator of five, that's a 50% higher rate of return. Now in my book, in fixed income, that's an attractive relative return and we are allocating about 10% to that asset class. Is 7.5% the same as making 40%? Of course not, but 7.5% versus 5%, is a still attractive spread and we like that category.

There will absolutely be corrections this year, just like there will be in the stock market. But, as long-term investors, if our macroeconomic outlook indicates growth and we believe corporate profits are growing on a long-term basis, then movements in the stock market do not dissuade us from being fully invested. In the high-yield category, at the end of the day, we believe that asset class will provide an additional return to investment grade fixed income. Those credits are worthy of holding in a growing economy. If we think that we're going to go into a recession, then allocation to high-yield would be much less or even zero within our fixed income space.

Q: Garrett, sticking with high-yield just for a second, as a follow-up, a year ago there were spreads of 2,000 basis points. They couldn't give them away and that's what created a very attractive buying opportunity. I get the question a lot about the default rate still rising. So is it your contention then that the spreads right now are compensating for a rising default rate as well?

A: Actually, that's correct. We have experienced and sophisticated credit analysis being done on every single individual credit we own in our high-yield opportunity fund. Let's call the peak for defaults, say by spring. So while the aggregate default rate might rise further, it's our contention that if you do the credit analysis the way it's done in our high-yield opportunity, you have the potential to be able to get a good return despite the fact that defaults still might peak. Again, let's all understand that investors on high-yields are looking forward. Because of the lack of the normal provision of credit, it's a lender's market, not a borrower's market. As a result, all of the terms and conditions that the borrowers once got away with have no chance of recurring because these banks are not going to allow terms to not be on their side.

This is what I believe is good for the future of high-yield and bank loans. There are hundreds of billions of dollars of bank loans and high-yield loans that have to get paid off and/or renewed or restructured over the next 24 months. You want to be renegotiating those terms as a banker or lender because you're basically going to get the price that you want or you're not going to make the loan. As investors, we are in the better side of that equation. Two or three years ago, Rochdale had an allocation to high-yield and bank loan equal to zero because we understood that it was a borrower's market and the lenders had to give the money away at a low spread. Therefore, we're not concerned and we think that there is a somewhat misinformed narrative being spoken about high-yield.

Q: Garrett, from an asset allocation standpoint again, you know most of Wall Street kind of operates on a two-dimensional asset class, which are stocks and bonds. We here at Rochdale tend to operate on more of a four-dimensional asset class, stocks and bonds, but also a third category of stocks that we call high-dividend and

income securities. We consider those securities a separate category than just equities in general. Then the fourth class is alternative investments. One of the additional ways that we help control clients' volatility throughout the most recent bear market, in addition to raising cash, is allocating a portion of the accounts when appropriate to non-correlated, low-volatility alternative types of investments. So now as the market is recovered, we've shifted our approach in this alternative asset class from that of a risk stabilizer to more of a return enhancer. Could you take a minute to maybe elaborate on both alternative investments as an asset class and just kind of explain exactly what the shift from risk stabilization to return enhancement incorporates?

A: Yes. If I could just mention that these are lower-correlated rather than non-correlated which means they add benefits to the portfolio. Now think of it as a flex defense, and our approach is the same. An alternative investing strategy can be low-volatility, moderate-volatility, or high-volatility. However, we are not talking about high-volatility, super-leveraged alternative strategies. That's not of interest to us in this conversation or context. We're talking about lower volatility, lower correlated strategies, and the way they are funded. There is and has been the tactic of funding it from either equities or funding it from fixed income, depending upon the specific purpose you want to achieve.

So, if I am a fully-invested client, I have 60% of my money in equities, 40% in fixed income, and let's say I understand alternatives can bring benefits. How do I fund that? Stocks generally give an 8% to 10% return and in fixed income you see just 5%, give or take, and they each have different characteristics of volatility. If we're looking to raise the return of the portfolio, we would pull the money from something that's earning 5%, which is fixed income, and allocate to an alternative that's expected to earn 7%. If we think we're going to go into a recession, we want to reduce our risky asset allocation, which is the equity side, and would allocate 10% out of equities into something that we know will earn less. However, in reality, if we're right about the downside and equities lose money, this will lose less money.

While the approach is always the same, it's the tactics that we change. For example, right now we're positive on the outlook so we want to be fully invested in equities. Additionally, because we do not believe fixed income returns are relatively that great, we're going to take 10 percent out of fixed income and put it into an alternative strategy that has breadth and depth in terms of other components to beat the return for fixed income with barely any increase in the overall risk of the portfolio. Furthermore, as we work with more advisors and more clients, I think this view, this notion of flexible implementation under the general approach of allocating to a low-correlated alternative investment to bring diversification to the portfolio, is something that they really embrace.

Q: Can you go into some more detail on the Fixed Income Opportunities Fund? Is it like a strategic bond fund where it's partially in high-yield or is it predominantly high-yield investing?

A: There are two components. One would be a category called senior secured bank loans and these are; if you can imagine going into your local bank as a business owner, you would borrow at prime plus two points or prime plus some spread, or LIBOR plus some spread. So that is an important component that sets them apart from high-yield. And while we like the high yield category, at some point there might be the risk of rising inflation. We know if you own a fixed income investment you're going to have a different outcome than if you have a floating rate investment. So in senior secured bank loans, we have the opportunity to have as much of a floating rate in that portfolio as we like.

However, because we believe they are safer than high yield, meaning the bank loans are secured by hard assets, they do provide a little bit less total return. Banks make loans based upon collateral. High-yield loans generally pay more, generate higher yields, and have higher appreciation potential, but they're a little bit more risky because they're fixed and they aren't really secured by hard asset collateral, they're secured by cash flows. Right now, the fund has a balance of about 65% high yield bonds and 35% bank loans, and that is a dynamic process that we undertake on a quarterly review.

Q: Are those the only two instruments that are used? No others are thrown into the mix along the way?

A: That's correct; we're sticking to those two categories. Again, I want to emphasize we are not a leveraged high-yield fund, this is not about leverage. It's straight fixed income but in those two particular categories. Also, we're not doing any derivatives, we're not doing any credit default swaps, we're not doing any mortgage-backed securities, we're not doing any CDOs, we're not doing any of those things that have, well, we all know what they have done. Now in summary, this is a



plain vanilla bank loan and high-yield. Furthermore, I appreciate the reason for your question, you were trying to get at the quality. Let's agree for the moment that you get what you deserve in fixed income. The fixed income markets are somewhat efficient. When you're looking at a typical high-yield bond fund, first of all, you have to understand that a lot of funds use leverage. Second, you have B-grade, C-grade, and D-grade. There is a well-known game, at least in Wall Street, where the high-yield managers will buy the C credits and the D credits. And in rising markets the junkiest of the junk rise the most. We're not in that spectrum. We're in the double-B and the single-B categories; we're almost in the investment grade.

Q: Can you comment a little bit on the commercial real estate market and your outlook?

A: First of all, thank you for the question. Commercial real estate is a disaster. It's going to continue to be a disaster for at least two more years. I think the latest assessment that we have is there's somewhere between \$800 billion and \$1.2 trillion due over the next two to four years. It's a lot of money, and 25% to 30% of all the commercial loans are going to lose a great deal of their value. First of all, what's happening is that the commercial banks and the commercial regional banks have most of the exposure as compared with JP Morgan, for example, and the losses on those loans have yet to be recognized. They're partially accrued for and the way we view this is the banks are being given money at effectively zero and they're doing what we all know is the carry trade. They're making lots of profit, borrowing at zero and investing in bonds and stuff like that. The Fed has telegraphed them to keep doing it and make as much money as possible so that when you incur those losses, you have some gains to offset them. So it's kind of like a shell game. It's kind of like a pact between the Federal Reserve, Central Banks, Treasury, and the banking industry where they have to create the profitability to absorb all of these losses. And it's going to be two to four years before the full extent of all these commercial real estate losses are recognized, realized, and written off. And all along the way the banks are going to announce some profits on their core business and then they're going to say, "What, we lost it all on the write-offs of commercial profits." That is really what has gone on every single time for the last five real estate cycles.

So in our view, it's not correct to say that because all these commercial real estate losses haven't been recognized and written off, it's going to cause an implosion down the road. Instead, I think it will extend or slow down the rate at which the banks will get back to providing that normal facilitation of credit, which is one of the key insights that I mentioned up front. As long as the banker is of the mindset that they do not know the full extent of their losses, they're not going to be making normal loans and this is one of the primary reasons our view is for a long, multiple-year, below-trend GDP growth period.

Q: Garrett, I believe the Bush tax cuts are going to be running out sometime this year and that would probably make the capital gains tax rise. Do you think this will create a sell-off before this happens, where people can take the lower capital gains tax and do you think that might create a pull back in the market sometime in the late summer?

A: I should have added extending those cuts to my wish list. Yes, any time you actually raise the taxes on some asset, the value of that asset drops. We do have that concern. However, it's actually the marginal change in the tax rate differential that really matters. David Abella is our resident expert on dividend-paying stocks and he and I were researching this recently. We've read everything that Obama and the financial wizards have said and they're suggesting that the dividend tax rate might go up or the cap gains tax rate might go up 5%. However, the implication of that is if you know if the tax goes up 5%, it's hard to have a 10% or 15% loss in value. Yes, it might impede some of the value of those capital gains or dividend-paying stocks, but it still would not dissuade us from being fully allocated to those asset classes. Reason being, ordinary rates on most of these same people are going to go up so the delta might actually stay the same. If you have a marginal tax rate that goes up 5% and a cap gains tax rate that goes up 5%, the differential hasn't really changed. So it's a moving target and it doesn't make us happy, but we're watching it.

Please don't take this as any high confidence assessment, but I think what they will do is extend it for some portion of investors and they'll cap it for others. So it's going to have a mitigated effect on the thought that people will cash in their gains before the cap gains rate goes up. Yes, some of that should be expected, but you're going to have a different set of movements each way. I would say generally speaking that is a second-order impact. The first order is, if we're growing as an economy and corporate profits are growing, stocks might go down a little bit due to the tax effect, but if the market's up 8% to 10%, you wouldn't notice the difference if at the end of the year, theoretically you can do it in an exposed analysis



and they should have been up 11%.

Q: You don't expect any real market correction this year at all?

A: On the contrary, my ability to predict the stock market corrections is zero, but I'm confident we will have a correction of 10% or 15% and it will be precipitated by something that we all know, that we hear every single day, whether it's either the dollar, oil, the deficit, Iran, or Obama's tax cuts. Investors will find a reason to blame it. At the end of the day if we do not have a double-dip recession and if we have corporate profits growing, \$78 this year, \$90 the following year, markets will reflect that and that's an 8% to 10% rise. So to me there's lots of noise and the siren that I'm looking to watch is GDP, corporate profits, and all of those other things will take a second seat to that.

Q: Will you talk about the Rochdale advantage in terms of what you see as the outlook for more frequent, but not as deep recessions?

A: That is a very insightful question. There's a lot of conversation about the end to the great moderation of the business cycle and the frequency of recessions going forward. A great deal of research has been done comparing the period that we're about to embark on as similar to the 1950's. That's where we had two or three years of growth followed by a year of recession, then two or three additional years of growth followed again by a recession. That differs in a material way from the eight or nine years of growth after the early 90s recession, and the six or seven years of growth after the 2001 recession. There is a reasonable case for this outlook. Think of an airplane, if an airplane is flying at a very high altitude and it hits an air pocket or it glides down for some reason, there's still plenty of space between the plane and the ground. Though, if our recoveries do not get that plane to 35,000 feet, but rather only to 8,000 feet or 10,000 feet, then there might not be strong enough momentum to the economy to keep it from crashing. There's not a lot of trust and any lesser type shocks could knock us off course and put us into the ground.

So, there are good reasons to think that this is a likely scenario, or greater risk over the next five or ten years. And if you're a buy-and-hold investor, I would seriously question being inflexible and adhering to staying fully invested if every two or three years we're going to have a pullback, a couple years of growth. That's not the right overarching philosophy in that type of environment.

Q: Going forward, what do you think about the dollar long-term if we're going to have these recessions and we're not going to have, let's say a very high 14,000-market again for a while? Do you anticipate the dollar can continue its gradual slope down and then maybe the yen becomes the world currency?

A: My bet would not be the yen, that's for sure. I actually don't find the yen long-term attractive. The way I would like to phrase the dynamics that are driving the dollar is that we probably have reached our highest marginal propensity growth rate as a nation, i.e., we're very big. We're somewhat a mature economy and the ability for us to grow at high rates just isn't there as they would be in some Asian economies or some Latin American economies. One hundred fifty years ago the U.K. was the dominant economy and the pound was the dominant currency. Today, with all due respect to our good friends over in Britain, who cares about that economy or that currency in this context? So it's a natural, not a shocking trend to see the dollar gradually decline relative to other economies whose secular growth, demographics, and productivity is on the ascent while ours is in a more mature phase.

So the risk there is a non-orderly decline. If we had something that's abrupt, that destabilizes investors in U.S. government bonds and could cause interest rates to rise, that is a risk factor. It's an event risk. Generally speaking the U.S. dollar, absent intermediate periods of some stability, is going to trend down in relation to other economies' currencies. You know if you want to change that trajectory the way to do that is not by running deficits in the trillions and having an under-investment and a low savings rate. Unfortunately, we're doing all of the things necessary to ensure that we are not the dominant growth economy in the world. There are ways to help change that around a little bit, but nobody in the last eight to 10 years has done anything about that at the governmental level policy-wise.

Q: We're going to have to start paying this off someday, probably sooner than later. How high can we go? Isn't that going to really block the market from doing anything going forward?

A: You and I see it the same. When we think of rising taxes, we cannot think about positive economic consequences. When we think of reduced spending it's often not positive, at least near-term economically. So we both agree that those factors are in train. They are going to happen, i.e., higher taxes and some modification to spending. They are not going to happen in 2010. President Obama has made the statement explicitly. He says, "I do not care about deficit spending during recessions." That's code for, "I need to get re-elected, so cut me a break. I'm going to keep spending money to create jobs and get the economy going."

So at some point who's going to stop the spending madness? Well, no one on this call thinks it's going to be Congress by their own volition, the market will discipline that spending. The way they'll discipline that spending is by saying we don't want your government bonds at the rate that you're offering interest. We need higher interest rates or we just don't want the bonds at all, and the credit rating agencies will put them on watch. There's a whole host of things that will change their behavior and then they're going to overreact. They always do because they're not disciplined to act in a productive way at the beginning.

All of this gives support for our view that this recovery will be moderate relative to any robust recovery. The sustained nature of the recovery is going to subject our economy to head winds or structural impediments for several years. That supports our investment allocation, which is overweight international and emerging markets on a global client portfolio, and underweight U.S. equity markets.

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