Special Update
Risk-Based Asset Allocation Long-Term Portfolio 1/25/2011

Executive Summary

The majority of the time we leave asset allocation decisions (how much to hold in cash and which stocks and bonds to own) up to our world-class stock and bond pickers because we believe our greatest value-add to clients is in selecting them and conducting due diligence. The risk in our Long-Term portfolios is effectively self regulated because our stock and bond pickers already react to the changing environment. We believe we can add *incremental* value by rebalancing portfolios when the economic growth rate cycle changes, if warranted by valuation. At the moment, although the broad US stock market is trading about 20% above fair value, we do not believe a wholesale risk reduction rebalancing is warranted. Specifically, we believe we are in a low inflation environment in a positive economic growth rate cycle that warrants higher valuations.

However, going forward we are prepared to reallocate portfolios if certain trigger points are reached. When we next observe an economic growth rate cycle downturn (as was triggered for instance in November of 2007) we will make a tactical asset allocation decision to reduce portfolio risk. We monitor this weekly for changes.

Risk-Based Asset Allocation

Our clients remember that we began incorporating lower volatility investments into their portfolios as early as 2006 and reallocating to volatility control managers at the end of 2007. In our Newsletter in January of 2008, we identified the likelihood of recession and began discussing the difference between volatility and permanent loss of capital. http://globalviewinv.com/wp-content/uploads/2010/10/Quarterly-Newsletter-to-Clients-Q1-2008.pdf. In later newsletters we proactively informed our clients to expect a continued correction, addressed the dangers of leverage and successfully encouraged our clients to stay invested in our strategies.

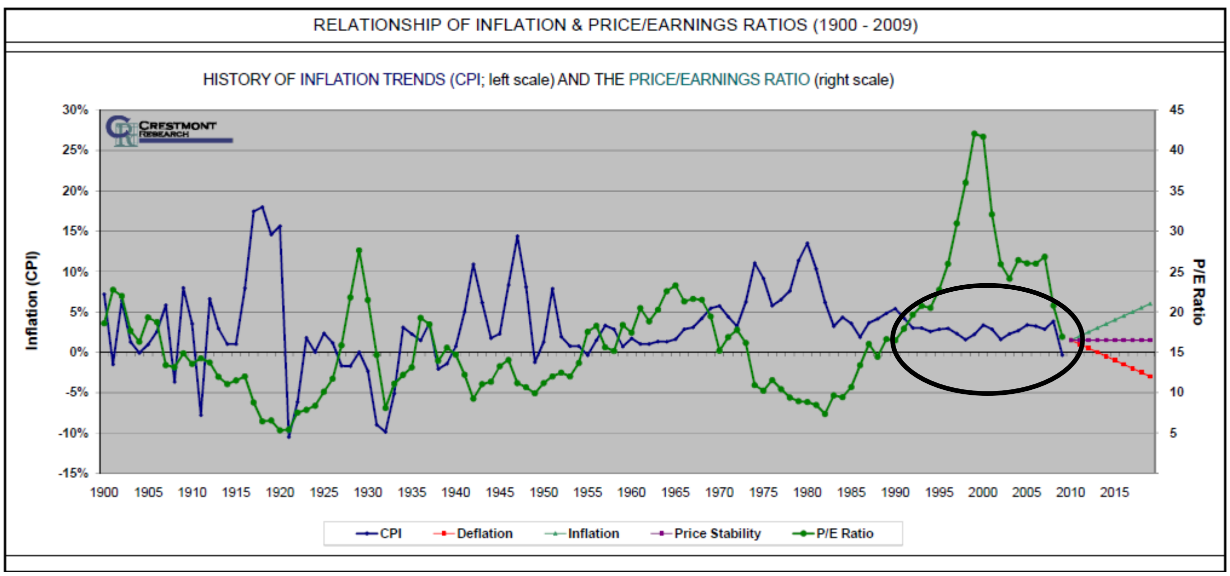
Our Risk-based asset allocation process is an extension of our valuation-based asset allocation methodology. While long-term valuation is what drives overall stock market index prices over the long run, much time can pass before valuation trumps other forces impacting prices. To quote Keynes, "*In the long run we are all dead*." We have found there is a strong correlation between economic growth rate expansion and changes in valuation multiples. This is important because when valuation multiples expand, stock prices typically rise. Alternatively, when they contract, stock prices typically fall. We intend to use this information to add risk adjusted return to our portfolios.

Valuation Framework

How much investors are willing to pay for earnings (the P/E ratio) varies significantly over time. This is because both earnings and prices are very cyclical in nature thus can be very volatile over short time periods. However, over long time horizons there is a more predictable pattern. Robert Shiller popularized a metric in his book Irrational Exuberance that we call the Shiller P/E. The Shiller P/E is calculated based on the inflation adjusted earnings for the past ten years. While this ratio is far superior to a multiple examining only 12 months of actual or future earnings, it is not perfect. Because the ratio looks at the trailing ten year period, it is based on starting and ending period of the ten year range. For example, at the end of an abnormally low earnings period the P/E may appear abnormally high, for example at the end of 2002 just as the economy was beginning to expand after a recession, the Shiller P/E was 23, a high value and an indicator of high risk to investing in equities just when they were beginning to rebound.

Crestmont Research did some additional work to normalize the ten-year P/E ratio further. This was accomplished by examining the relationship between economic growth and earnings to establish a long-term trend. We feel this is superior because it normalizes the long-term trend around the business cycle by using expected earnings instead of reported earnings, thereby smoothing the ratio and eliminating the problem noted above with the Shiller P/E in 2002.

The chart below shows a comparison of the long-term ratio of price to earnings (green line) against inflation (blue line). Clearly the highest multiples occur around areas of price stability, i.e. low inflation and a lack of deflation. The black oval shows the period from the 1990s to current where inflation has generally been subdued.



The long-term average of this ratio, which we call the Normalized P/E, is 15.5.

Current Valuation

As of the end of 2010, the S&P 500 traded at a Normalized P/E of 19.5. While this is above the historical average, it is not far from an expected multiple at current levels of inflation. In fact, at levels of inflation from 2-3% p.a., the average Normalized P/E from 1900-2009 is 22. Due to the headwinds facing the economy, and despite the underlying economic growth rate cycle, we would expect the broad S&P 500 to trade in a range between 900 and 1500. While the market may continue to rise above that, we would need some overwhelming confirmation of a new trend to believe such valuation is sustainable. Our current Average Fair Value of the S&P 500 is 1050. This was calculated by taking the average values from five different firms. At today's price, we are a little over 20% above fair value. While this is a cause for concern, it is not a cause for alarm. First, stocks have typically traded above fair value. Second, our long-term portfolio is only about 35% exposed to US equities (and about 35% to overseas equities which trader closer to fair value). Third, and most importantly, our managers use a Margin of Safety approach to select individual stocks and bonds with a focus on reduction of permanent loss of capital risk. Finally, we have found that during periods of economic expansion, i.e. when the growth rate in the economy is increasing, the multiples investors are willing to pay for earnings typically expand raising equity prices with them.

There is a wide range of potential outcomes, but high inflation generally results in lower valuation multiples. Below are expected values of the S&P 500 at higher inflation ranges :

Inflation	Normalized P/E	Implied Value of S&P 500
4-5%	16	1024
5-6%	15	960
6-10%	13	832
> 10%	8	512

Economic Growth Rate Cycle and Stock Prices

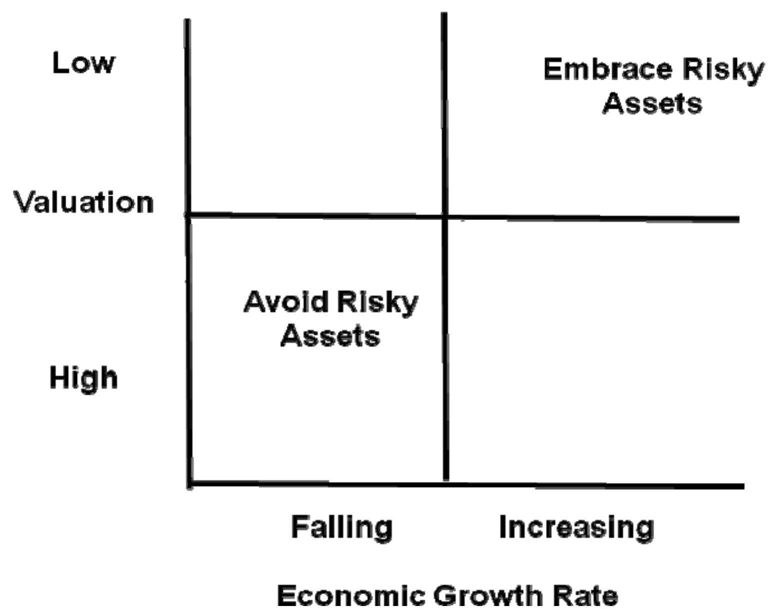
While there are many forces at work, turns up and down in the stock market have historically been highly correlated with a *change in the growth rate* of the economy. Therefore, information on when these changes occur is highly valuable. Unfortunately, while there are many economic forecasters, few add measurable value. We have spent the last year reviewing publications and research by to learn if any forecasts have predictive value for our purposes. The Economic Cycle Research Institute (ECRI) does an excellent job predicting turning points in the economy that are highly correlated with a directional change in stock market prices. The real value is NOT in calling a recession or a recovery, but calling a change in the growth rate. They regularly publish this information. The chart below shows 6 inflection points, 3 growth rate cycle upturns, shown in green, and 3 growth rate cycle downturns, shown in red. Following ECRI's call of a growth rate cycle upturn, stocks rose. Following ECRI's call of a growth rate cycle downturn, they fell.

ECRI Call Date	ECRI Call	S&P 500 adjusted close	Cycle Return (to previous)
11/30/2010	US Growth rate cycle upturn	1,181	n.a.
2/19/2010	Growth rate cycle downturn	1,109	32%
4/2/2009	Growth rate cycle upturn	843	-44%
11/2/2007	Growth rate cycle downturn	**1,510**	56%
7/1/2002	Growth rate cycle upturn	969	-30%
10/27/2000	Growth rate cycle downturn, possible recession	**1,380**	n.a.

It is important to make the distinction between rising and falling growth and contraction or expansion. The growth rate cycle consists of periods of rising and falling economic growth. The growth rate cycle may be in a downturn, even when the economy is expanding (albeit more slowly). Growth rate cycles are sustained periods of simultaneous upward or downward movement in the growth rates of output, employment, income and sales. For example, if the economy is currently growing at 5%, but starts growing at only 3%, this is a growth rate cycle downturn. If it slips below 3%, this is a growth rate cycle recession. Remember, at no point in this scenario would the economy be in a classical business cycle recession or contraction.

More often than not, there was little actionable information in ECRI statements (for our purposes) because there was no significant change to report. Moreover, one can read too much into a single indicator and make false conclusions. ECRI makes their call (a turn in the economic growth rate cycle) based on an examination of multiple proprietary indicators. The Long leading indicator is only published to professional subscribers. This indicator is used to indicate a turn in the economy about a year in advance. This indicator, in combination with the Weekly Leading Index and others, is used to predict a change in the economic growth rate cycle. Their last call, November 30, 2010 was an increase in the economic growth rate cycle.
http://www.businesscycle.com/news/press/2026/

When to Reallocate:
We can use this information, in conjunction with our estimation of fair value, to reallocate client portfolios when economic growth rate changes occur. When valuations are high and the economic growth rate is falling, we will avoid risky assets, as illustrated in the chart at right. Similarly, if valuations are low and the economic growth rate is increasing, we will embrace risky assets.



In a falling economic growth rate cycle expansion it is almost always a good time to avoid risk unless valuations become very compelling.

Similarly, while the economic growth rate is in an increasing cycle, it makes sense to take prudent risk (through our margin of safety managers) even though valuations are high. During these time periods (most of the time), we will generally allow our managers to do what they do best, which is to self regulate risk by selecting assets that afford a margin of safety.

Global View Investment Advisors Team

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