

Investment Insight

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2011 Market and Economic Outlook



A conversation with:
Garrett R. D'Alessandro CFA, CAIA, AIF®
Chief Executive Officer & President, and
Steven Denike
Portfolio Strategy Analyst

Highlights:

- The 2011 outlook for the U.S. economy is a solid, sustained expansion.
- Households are making progress on repairing their balance sheets, but are still managing to spend.
- The labor market continues to improve, but a full recovery will be a multi-year experience.
- Near-term housing market volatility is expected to give way to stabilization and then slowly recover by year end.
- Despite concerns over inflation and central bank tightening, rapidly developing emerging markets continue to drive global growth.
- Equity market outlook remains positive.

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 20, 2011 Advisor Forum Conference Call.

Today we will be discussing Rochdale's 2011 market and economic outlook. In taking a look back at 2010, it started off kind of rocky, but turned out to be better for equities than many folks had expected. It seems that economic growth really strengthened throughout the year and the markets recovered in the third quarter. The theme for the conversation today is, "Keep it Simple and Stay Focused." What we mean by this is that our outlook for 2011 is focused on several key points: monetary policy, fiscal policy, corporate earnings, interest rates, and inflation. We will talk about each one of these components individually.

Q: As we transition into 2011, what would your outlook on the economy be going forward and what do you think the risks of that outlook might be?

A: Let's talk about corporate earnings. This year we are looking at another strong year for the S&P 500 in terms of EPS (Earnings Per Share) growth and the level of earnings. Based on the level of earnings, we believe that the market is reasonably valued around 13 to 14 times and we expect very good global growth to complement the reasonably good domestic growth. On that point, we give the score card an A-minus.

When we talk about interest rates and inflation, all of our leading indicators of inflation tell us not to worry this year, so on that score we give it an A. When we look at monetary policy, we note that the current printing presses are on and Bernanke, by all of our assessments, is going to continue and finish up with the current QE2 (Quantitative Easing) program. Since we do not see any signs that he is going to stop doing that, we give monetary policy a B-plus.

When it relates to fiscal policy, there are a lot of things to complain about in terms of the government spending too much, but we cannot deny the fact that about 80% of the time, in the third year of a presidential cycle, the stock market goes up. The reason being is that government starts their fiscal stimulus to improve their re-election campaign.

Generally speaking, these factors are not all as well-aligned as they are presently. If we go back over long periods of time and add up the number of years where we have positive fiscal stimulus, positive monetary stimulus, low inflation, low interest rates, reasonable and attractive valuations, and strong corporate profit, it is about less than 20% of the time. Our conclusion is that we think 3%, maybe 3.5% GDP growth. We also see stock prices 8% to 10% higher at the S&P level and that is our positioning within client portfolios.

Q: It seems like much of the raised outlook is policy-driven and at some point the bill for all of this stimulus and spending needs to come due. That was very apparent in the elections last fall. Being that this path we are on is unsustainable, when do you feel the federal debt will become an issue and how do we deal with this?

A: So, we gave all the good news up front, but here is where we think a lot of market participants are being led off track. I want to focus on the theme which is "Keep it Simple and Stay Focused." As was stated, it is not often that you have those factors all going in the right direction, and when they are, the bigger issues such as the unsustainable nature of the federal deficit, the tax situation, the healthcare uncertainty, and other more intractable problems are being pushed aside.

So, let me talk specifically about this problem that we, as Americans, are all dealing with, in terms of the current level of annual deficit and the accumulated fiscal budget deficit. The short history of this is that anytime a major economy goes through the combination of a tremendous banking crisis, a housing meltdown, and a generalized economic recession; the consequences are that the government of that particular country starts to accumulate massive amounts of debt. They are bailing out banks, bailing out the housing market, and/or making transfer payments to the massive amounts of people unemployed.

My conclusion for the way we get out of this - is a crisis. Watch any video or read any news clips on the European financial crisis and know that that will be coming to the U.S. at some point in the future. Why do I say this? The simple reason is that the political establishment has not demonstrated a single ounce of willingness to speak honestly to the American people and tell us that we have lived beyond our means for many years. We have major structural deficiencies in the balance between the revenue and the expenses. We need to have all Americans make major sacrifices for many years so that we can bring our governmental expenses in line with our governmental revenues.

We have seen no evidence, whatsoever, that the political leadership has that skill, whether it is at the federal or state level. So, what will precipitate is a crisis. This projected unsustainability is going to cause some implosion in the financial system of the United States. We have a manageable level of debt today, but again, if you projected out two years, five years, ten years, twenty years, it is not sustainable.

We estimate that somewhere between today and the next five years, we are going to have this crisis and when I call it a crisis, there are many shapes and configurations it could take. It does not have to be an explosion. A lot of people are predicting an explosion where interest rates go soaring up and the government comes crashing down. That is not what I mean by a crisis. A crisis is the acknowledgement of the market participants, the people who are lending money to the government, that the government is at the tipping point. They are not going to continue to lend money at the rate at which the government is paying interest, and that will re-establish the terms upon which the government can borrow.

So, even though we have these unsustainable debts, we do not think it is going to derail the economic recovery

Q: You made the statement calling on all Americans to make major sacrifices, probably much of that will be involuntary, but historically the consumer has been 70% of our economy. You have also said that a retrenching consumer would be the number one constraint on potential economic growth. Given the outlook for a modest jobs recovery, how long would you expect this process to continue?

A: The consumer needs to go through a deleveraging phase, or a phase where they have to lower the amount of credit card, car loan, and mortgage debt that they have accumulated. If we were to start back at the beginning of this debt crisis, we are at least at the halfway point. On a scale of 100, where 100 is too much debt, we are at about 50. Historically, when this deleveraging process reaches this current halfway point, the consumer starts to re-establish more normal consumptive behavior patterns.

We think that the job market will have a heavy influence on this. As we look at things today, the consumer is going to be in a good enough condition to spend at about a 3% rate of growth and that is underpinning our generally positive view on the overall economy for 2011.

What is helping households, in addition to them lowering the debt that they have, is that interest rates remain low and wages are generally getting a little better. Home values in several parts of the country have stabilized, and when you put that together with an improved sentiment, the news flow gets a little better, the outlook is a little better, and the consumer should be OK in 2011.

Q: I think that underpinning all of this now is the labor market. It really seems to be the answer to a lot of things. Let me turn this question over to you Steve, when do you think companies will begin hiring more? Do you think they will be a little more aggressive? What is your outlook for the unemployment rate as we move through the year?

A: The labor market is obviously important. As we have noted, jobs and income growth are the number one factors influencing a consumer's willingness to spend. The good news is that we have now had a long and continuously improving run of monthly job reports. The hiring is increasingly widespread throughout the private sector. We had 1.1 million jobs created in 2010. While a lot of people do not realize this, this is significantly better than the last two recessions. Unemployment has now dropped to our lowest level in two years and even the small business sector, where half of the job growth typically comes from, is showing signs of joining the recovery and expansion.

However, as December's disappointing payroll shows us, the expectations for the labor recovery and prospects for 2011 should be kept in check. We know historically that the primary determinants behind businesses hiring are corporate profitability and confidence. However, we have seen a disconnect between that historical relationship this

cycle. While profit growth has been remarkably strong, job growth has been decidedly lackluster. What I mean by that is corporate profits, as well as the broader economy, have recovered from recession lows, and we expect they will reach record levels in 2011. That is all being done with roughly 7 million fewer workers.

The reason behind this is threefold. Number one, corporate uncertainty over healthcare costs, regulations, and taxes, as well as the overall economic forecast and expectations are making businesses hesitant to hire. Number two, businesses remain focused on cutting costs and improving their bottom lines through efficiency. This has led them to substitute capital and technology over more costly workers. Number three is global competition. Businesses are increasingly outsourcing to countries where the cost of labor is cheaper.

Now some of this uncertainty has abated. A recent budget compromise was helpful and economic expectations improved. There is also a limit to how much further corporations can increase productivity without having to resort to new hires and meet increasing demand, but overall we expect these three factors to, in large part, remain in place going forward.

Additionally, although we expect hiring to continue and improve, the 115,000 average monthly job gain we are forecasting in 2011 is not significant enough to keep pace with the natural speed of population growth. Also, global competition has left millions of Americans structurally unemployed and it is going to take years for those people to be re-trained and re-skilled to compete in the global workplace.

Therefore, we are expecting it to take several years to reduce unemployment to a more reasonable level of 5% to 6%. For 2011, we are expecting the unemployment rate to only be about 9% by year end. The bottom line is that the labor market, for now, is generating enough new jobs and enough sufficient income growth for consumer spending rates to gradually improve to a more normal rate over the course of the year. That is the basis for why we recently bumped our economic forecast from 3% to an upside surprise of 3.5% for the year.

Q: We have been talking about consumer spending and unemployment, but I would be remiss not to talk about real state. Equity prices have rebounded quite a bit and we have made a good portion of the decline back, but home prices have really lagged. I think one of the key questions on everybody's mind is what homes are going to be worth and what is going to happen to real estate as we move forward. Broadly speaking, do you see the housing market getting any better?

A: Understandably, the recent trend of home prices has left a lot of people nervous. Prices fell 0.8% from early October. This was twice as much as expected and it is also the first time

the index turned negative since last January. Additionally, it was the fourth, consecutive, monthly decline in home prices since the summer.

However, the housing market is not necessarily in any worse shape than these numbers would lead someone to believe. The home buyer tax credit was propping up demand and prices, while foreclosures were raising inventories. On the positive side, home affordability measures such as price-to-rent ratios and mortgage service costs have significantly improved. We also learned, just today, that existing home sales jumped 12.3% in December. This has retraced most, if not all, of the declines since the homebuyer's tax credit expired mid-year.

The sales are not modestly above their 12-month averages and inventories are now at an 8.1 monthly supply, that is the lowest level since March, and that is positive. That serves as the counterbalance from the negative news, but we should not get too excited either way. For now, it is reasonable to expect that housing activities, sales, and construction will bounce along the bottom for at least the first half of the year into the third quarter, and further home price declines in the near term may be likely.

Still, what we want to ingrain here is that we expect demand to grow and housing prices to end up flat. Patience is important. We are forecasting the beginnings of a recovery in the housing market by year end. What is key here is that housing starts (residential building construction projects) are currently averaging about 500,000 per month. This is roughly half, maybe a little less, the level necessary to keep up with population growth. There is pent-up demand, but consumer deleveraging, reduced net worth, and uncertainty about jobs are holding back that pent-up demand from being expressed right now.

Typically, the pent-up demand for housing is a driver of recovery. This is also a major reason why we have not seen the more robust recovering consumer spending rates of 4% to 5%, which are more normal, and that is why we are forecasting somewhere around 3% for 2011. The silver lining in all this is that the housing recovery should not be necessary for the broader economic recovery to take hold. The housing sector, right now, is a much smaller portion of the overall economy than it was at pre-crisis levels.

Q: If we take a broader look at the macro perspective, it seems the United States has been slowly relinquishing some of its leadership position in a number of industries over the last couple of decades. I know at Rochdale, we have talked about the need to rebalance the economy from consumption-based to one of more investment and production-based. Consumer spending is forecasted to be considerably lower than what would be typical at this stage of a recovery. Can manufacturing and export growth pick up some of this economic slack from the consumer and possibly help grow

our job base further?

A: Sure it can, and we expect it will to a degree. However, there are fundamental issues that will hold back any real type of rebalancing that we feel is necessary for the economy. For a long time the U.S. has enjoyed a unique, competitive strength. We continue to be a highly innovative, dynamic, resilient economy, but it is true that over the past three decades, we as a nation have been gradually losing our competitive advantage in an increasingly competitive world. We studied a lot on this topic and we have looked at a lot of empirical research. For those interested, there is an invaluable read written by Michael Porter, called [The Competitive Advantage of Nations](#), and we also have a piece in the September 2010 Rochdale Report addressing this topic.

The bottom line is that we, as a nation, have become increasingly wealth-driven rather than investment driven, meaning our emphasis has been more on preserving wealth, rather than innovating and setting the conditions for growth. This comes from the top down. Government policy, however well intentioned it may be, has focused increasingly on social programs rather than fostering the conditions for investments to maintain our competitive advantage in the global economy. The result of this is a loss of industry to our overseas rivals where the cost of labor or capital is cheaper and investment is higher. In the process, we have been left with millions of Americans that are structurally unemployed. So, more government spending will be needed which reduces the available private sector capital and the wealth transfer from the productive sector of the economy to the unproductive, which in turn reduces growth potential and the overall standard of living for all Americans.

What we truly need is a long-term, strategic, national, competitive policy that focuses on the following points. First and foremost is education. Number two are incentives for firms to innovate; we need robust research and development to foster commercialization of research. We also need high level immigration skills to supplement our workforce. We need expanded public infrastructure, technology investment, and balanced regulation, as well as taxes with industrial policy goals.

It is not a question of money; it is a question of policy. Let's take education as an example. American students are falling behind their global peers in achievement scores, but the U.S. gets 60% less for its education dollars, in terms of average test score results, than other wealthy nations do. Likewise, how much of last year's stimulus bill actually resulted in any valuable infrastructure building? There seems to be a general consensus forming right now that something needs to be done about our global competitiveness. Yet the U.S. has not given any real indication that we are seriously moving on this problem.

We may see some progress made in some of these areas later in the year. For example, the U.S. corporate tax rate is the world's highest for the first time in a long time, so there is a good chance for a meaningful tax reform later in the year. But by and large, we see no real evidence that the fundamental problems that we have identified are being addressed. While we expect some of the slack from reduced consumer spending to pick up by manufacturing or from increased export growth, we believe, it will take a long time before the structural problems that are holding back a rebalancing of the economy, to be fundamentally addressed.

Q: Now we will turn it back to you Garrett, I think the global outlook is a bit brighter than it was a few months ago and it is primarily due to the continued development of the emerging economies. However, can emerging market growth be sustained, especially given that inflation seems to be a growing concern and is leading to some tightening in monetary conditions? I know China specifically has just raised rates. What are your thoughts on the emerging market economies and where they stand, as well as where they are heading?

A: I think everybody has an appreciation for the criticalities of the emerging markets to the global economy, but let me just give you a statistic, 50% of the net growth in global GDP is coming from the emerging markets. Stop and think about that. More than half of the growth in the entire global economy is coming from less than 25% of the global GDP producers, so they are contributing an outsized benefit to the world's economic activity.

In terms of, can they continue to sustain their rates of growth? There has been a lot written about all the problems, the bubbles, the Communism, and countless others. I actually just got back from China and would estimate that the sustainable rate of growth in China is 7% to 8% for another 10 years. I was in meetings for days with senior government officials and leaders of business and their problem is keeping growth from coming too fast. However, they have no concerns on whether growth will be sustainable.

Their challenge is just the opposite. I see China with 8% to 9% growth in 2011. Generally speaking, the population dividend that China has benefited from over the last 20 years is going to come to a peak later in this decade. After that, the decline over the subsequent several decades will result in China's working population declining by 200 million people. That is almost two times the entire labor force of the United States. With that being said, they are still going to have millions of people working so it is not as if they are not going to be a big economy. In my opinion there is no question that China will pass the U.S., and there is a lot of speculation on this, but we believe it is a certainty.

India, a totally different economy and different political system, suffers from many of the same areas that China excels

at. China excels at industry, manufacturing, production, infrastructure, and I can go on. India does not have any of this. India, unlike China, is consumptive internally. China is export driven, but nevertheless, China's economy is growing robustly. India is looking at about 8% to 8.5% for 2011. India is starting to experience the population dividend, and out of all of the emerging markets will have the biggest increase in the working labor force over the next one or two decades. At about the same time China's work force will be peaking.

During my time in China, I found that U.S. newspapers are quite different than Chinese newspapers. For example, I was getting all of the daily Chinese newspapers as well as the Western newspapers, and it was as if I was reading about two different countries, it really depended on the newspaper I was reading. So, is there a bubble in China that is going to burst? I don't believe so. Are there other markets where housing prices are too high? Absolutely. Will they come down? Absolutely. Will that derail the growth in China or will that derail the growth in the emerging market? In my opinion, absolutely not.

The other topic of the day is all of the bad debts in the Chinese Banks. The only thing I can say about that is - one should not cast stones if one lives in a glass house. If all of the bad debts were to come true, it would most likely still not negatively impact the Chinese economies. The simple reason is the state owns a good majority of those banks and the state, last time I counted, has \$3 trillion in foreign reserve. Let me put that into perspective. If the U.S. stock market is roughly worth \$15 trillion, and if China took the excess money they make every year; that is another \$300 billion that they essentially have sitting around in cash. They could buy 20% of every single company in the S&P 500 tomorrow, and I can go into more implications like this.

So, we are very positive on the emerging markets and we feel they are necessary for the continuation of the U.S. economic growth, as well as overall positive stock market expectations.

Q: Garrett, listening to your answer on the emerging economies, it seems like the exact opposite is occurring in the developed world. We had the Greece bailout last year, the problems in Ireland at the end of the year, and just yesterday, Spain said that they are going to inject money into their banking system. What are your thoughts on the European sovereign debt problems? How will it be resolved? Is Europe specifically heading for a double-dip recession? Could you talk a little bit about some of those economies?

A: Again, when I was in China, I was in some senior meetings in Beijing, and we spent a half day on Europe. The reason we spent a half day on Europe is because the Chinese have so much money that their senior policy makers are trying to figure out how much money they want invested in the bonds of several of these countries. We were provided a very illuminating assessment of each of these countries by several

of the global banks. The bottom line first, Greece, will not in my lifetime ever honor all of the debts that they have, so they are going to restructure, renege, and redo things. When they actually choose to do it, no one knows. The same goes for Ireland and Portugal.

Spain, on the other hand, can stand on its own. Yes, they have some banking problems and some debt problems, but they have the internal fiscal ability to solve their problems. Similar for Italy. We do not see Spain and/or Italy imploding, renegeing, or having to restructure their debts.

Now Japan, which is not in the European sphere, is an enigma to us. There is no conceivable way that we can see the Japanese honoring the debts of their government, being that it is not sustainable. In addition, the only reason why it has not imploded is because the government is issuing the debt, and the post office that the government controls is buying all of the debt, which in our view is a Ponzi scheme.

However, will that affect global growth? The good news about Europe is, though they are about 30% of global GDP, they have contributed very little to the growth of the global economic environment. What I mean by that is those countries, in aggregate, for many years were averaging about 1% growth, so they were only contributing maybe 20% max to the overall global growth environment. If that gets cut in half, it should not have a devastating effect on global growth.

We do not think that the economic risks, from Europe, are as significant as the financial contagion risks. By significant, I mean that not tomorrow or next month will Greece, Italy, Ireland, and/or Portugal cause the U.S. to have a financial problem. It is the cost of borrowing within those governments that are potentially going to raise the red flag and the cost for U.S. government debt to rise. If that happens, then you have a contagion effect that will slow down the ability of the U.S. government to do fiscal stimulus and other issues of that nature. But we are watching each one of these risk factors, and do not think it will cause too much damage in 2011.

Q: I am going to turn our attention to Rochdale's portfolio strategy. One of the big themes for 2011 is the implication of everything you have discussed today on the fixed income markets. You have touched on the long-term structural imbalances of the United States; certainly the state and local fiscal finances are not in any better shape. The bond market is at a crossroads and may be in a position that many investors and advisors have not had to experience before. Specifically, Garrett, what would you be recommending to Fixed-Income investors in terms of navigating what is down the road?

A: Each client specifically has their own suitability based on their investment objectives. When I am giving you specific ideas, I am not relating what one advisor should do in any particular client portfolio. We do not own and do not want to own anything long-dated, meaning 10-plus years. The reason for that is the potential for forces that could create

monetary or nominal inflation, which is potentially risky.

We do not see wages and housing prices causing inflation, so we do not want to own long-dated fixed financial instruments. Furthermore, we do not want to own governmental debt instruments, whether they are federal or state, since we do not have high confidence that owning a big portion of that within the fixed portfolio gives us the right return for the risks present.

Said more simply, Bernanke and his team are manipulating interest rates below what they should be. We believe that given the risk, we should get a somewhat higher rate of return for government funds. We are good investors and we do not like to be underpaid for the risk that we are taking.

So what are we investing in within Fixed Income? We like the higher yielding areas. That would include items below investment grade. We like the emerging market, short-term, fixed income market. We like that market because not only are our current yields good, but when you earn interest rates in the emerging market, the way we invest, you earn them on a floating rate basis. So, it is a LIBOR plus spread and that mitigates the concerns of what happens if interest rates start to rise. We also like a variety of our specialty, fixed income, investment funds. They give nice rates of return, have low volatility, and they repay principal and interest. Those are the three areas that we like in fixed income.

Q: Garrett, if we move on to the equity market, last year the stock market ended positively, but it certainly was not a straight climb up. I think what sticks out for many investors, in stark contrast to some of the headlines they read about in the newspaper, and looking at the broader economy, is really how strong the earnings recovery has been. Would you expand on that a little? What specifically would be your investment focus moving forward in the equity markets?

A: Last year we moved client portfolios to an equity weighting within the allocations at the mid to upper ranges. This year, we want it to be suitable, appropriate, and meet the client's investment objective. We want their equity exposures to be at the upper ends of all allowable ranges. With that said, our S&P estimated returns are 8% to 10% for 2011. You can add 1% or 2% as you go down the capitalization scale and you can add 1% or 2% as you go into emerging markets. So, if we are looking at a Mid Cap in the U.S., you are looking at 10% to 11%, if you are looking at Mid-Small Cap in emerging markets you are looking at 12% to 13% rates of return.

Those are obviously quite attractive so that is why we are at the overweight or upper end of the allowable equity ranges. Going back to my opening theme, "Keep it Simple and Stay Focused", you do not need to get too fancy right now in our view. Get invested in the equity classes that will generate the right balance of risk and return and benefit from strong corporate earnings growth, reasonable valuations, low rates of inflation, and supportive monetary and fiscal policy.

Stated before, about 80% of the time during a presidential cycle, stocks go up in the third year. A lot of people might think that is just coincidence but we do not care if it is coincidence, it is history and we like history on our side. Corporations are running an aggressive, maintenance cost reduction and they are not going to stop. A lot of the experts were complaining about the quality of the corporate earnings in relation to cost-cutting and everything else. I think about 65% or 70% of all S&P companies have been beating on the revenue, as well as on the cost side.

The rate of growth in revenue is not 10%, it is 3% or 4%, but when you are cutting your expenses, that can translate to an 8% to 10% profit growth. When we look at EPS for 2011, and note that we have been constantly upgrading this, we are at \$92 to \$93 right now, and that is a great number. I think the peak was \$88 or \$90, so in this year we should surpass the all time previous record for any year of corporate earnings for the S&P 500. I believe in the first or second quarter of 2011, GDP of this country will achieve an all time new high. It will break above the prior peak set back in 2007. With all of the negativity that we hear in the press, you do not hear that corporate profits are at a record high, GDP is at a record high, and the S&P 500 is nowhere near the 1550 mark, it is around 1270. It is 20% below where it was several years ago despite the fact that we have higher earnings and higher GDP.

It is not unreasonable to say that equities are rather reasonable valuation relative to where corporate profits and GDP are. So what do we like? We like the same things that we liked last year. If it works and it is not necessary to change, we are not going to change.

We are heavily allocated to the dividend category. We are allocated to the S&P 500. We are allocated internationally and during this year we are going to increase that allocation meaningfully. However, not at this very minute because we have issues in terms of timing and credit cycles in the emerging markets that are going to buffer that equity the first half of the year.

Q: Speaking of markets, and one of the things that scares me a little, is that it feels like our stock market is becoming held hostage with traders, such as hedge funds, computerized trading, and algorithmic trading. The non-fundamental traders now account for 60% of the market volume which is very apparent when you look at the elevated levels of volatility. You have spoken a lot about this “new normal” and the rise in the market of what you have termed “Meta Risk” factors. Could you expand on this? Is fundamental trading dead? What road does an advance risk mitigation system have in today’s portfolios and how do we mitigate some of this volatility?

A: You know this is the theme that we have had, and quite frankly, it helped our clients in a very significant way during

the last bear market. Let me draw a conclusion first, if you believe that the stock you pick, IBM for example, based upon a fundamental analysis determines 80% or 90% of your portfolios return and volatility, you are absolutely wrong. The day that the stock you buy drives your portfolio’s performance and the portfolio’s volatility is long gone, and that is what I mean by Meta Risks. They have swamped the fundamental characteristics of the companies that we invest in. I do not like it, I do not want any part of these new Meta type risks rolling and landing on my fundamental decision making, but they are absolutely swamping the fundamental security selection process. The implications of that are very significant and they are addressed only by implementing new, Dynamic Equity Risk Management methodologies.

If you know the buy-and-hold philosophy, which we love as a philosophy, and kneel at the altar of fundamental long-term buy-and-hold. We are not ignorant of the fact that when a systematic risk factor, such as quantitative algorithmic trading, gets into high gear and creates excessive amounts of volatility, those stocks that I buy within my portfolio lose their individual characteristics. They take on a characteristic that I do not want any part of. As a result, we have two approaches to managing risk.

When managing client portfolios we start with an individual assessment of the risk budget. Numerically thinking, the maximum risk that someone could take is a 10 and the minimum is a 1, so we identify where they are on a risk spectrum by giving them a number. We then spend time with the financial advisors and calibrate that to a percentage of the value of their portfolio. If the client has \$10 million and they scored a 3, we convert that to an 8% downside during normal times and 14% during excessive times. If you multiply that by the \$10 million we come up with \$800,000 to \$1.4 million. That is the first approach we use so we can construct the portfolio to fit within the downside allowable range.

The second approach is more of a circuit breaker approach and we call it the Dynamic Equity Risk Management approach. The simple analogy: if I am in my home and I plug a couple of different electronics into an outlet and I overload the outlet, I do not burn down my house, because people have recognized that they can implement a circuit breaker to turn off. If we were to do that without the circuit breaker, my house would burn down. So in terms of a portfolio, we have identified seven sources of Meta Risk.

I will name a few; hedge funds, leverage in the financial system, quantitative trading, and the principle of reflexivity. So we have these Meta type risks and we do not know when they are going to catch on fire, but when they do, we do not want to be sitting around idly seeing our portfolio, which we think is well diversified, all of a sudden become homogenized. We want something to stop that portfolio from universally correlating to one and going down all at

the same time. It is a very sophisticated approach, but it is applied in a personalized way with our portfolio managers and our technology system. For more information on our Dynamic Equity Risk Management approach, please email info@rochdale.com.

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The asset classes listed involve contrasting risk factors.

Cash-equivalent investments have fluctuated the least and have been relatively stable.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

The investor should note that vehicles that invest in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Indexes are unmanaged and investors are not able to invest directly into any index.

International investing involves special risks including greater economic and political instability, as well as currency fluctuation risks, which may be even greater in emerging markets.

Investments in stocks of small companies involve additional risks. Smaller companies typically have a higher risk of failure, and are not as well established as larger blue-chip companies. Historically, smaller-company stocks have experienced a greater degree of market volatility than the overall market average.

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