VICTORIA
Capital Management, Inc.

GLOBAL FINANCIAL MARKETS PERSPECTIVE

APRIL 2010

Investing Gets Better With Time

The U.S. economy is out of intensive care and on the way to a reasonably normal cyclical recovery. The world economy is not far behind due to global policies of fiscal stimulus accompanied by low interest rates around the globe. Expansionary government policies have triggered a rebound in growth across the Pacific, Latin America and, to a lesser extent, in Europe. The "Old World" is also on the mend even though a rash of bad economic policies in Greece, Portugal and Spain could continue to have financial consequences for the Eurozone. The problem is that there is no central fiscal authority in Europe as there is in America. As a result, individual countries are required to abide by the rules of the Maastricht Treaty that created the European Union. One rule is a restriction on running budget deficits. Of course the recent economic downturn pushed the weakest countries beyond the 3% limit causing uncertainty that a failure of one country could affect the entire continent.

Over the past twelve months, the world stock markets, as measured by the MSCI World Index rose by 51.6% as compared with a gain of 49.8% for the S&P 500. Improving economies usually follow in the tracks of stock market rallies and continued economic expansion appears to be likely for the balance of 2010 and early 2011. According to Citigroup's Economic Research Department, overall global growth is expected to be 3.5% in 2010 and 3.3% in 2011, after a decline of 1.4% in 2009.

The first quarter of 2010 did get off to a slow start probably due to a surprise increase in bank taxes imposed by the Obama administration that then the feared collapse of Greece in response to sizeable budget deficits pushed the S&P 500 down 3.6% in January but as economic statistics continued to improve the stock market recovered that loss in February rebounding 3.1% and then March experienced a 6% surge closing out an above average 5.4%quarter for equities.

Even with the recovery in the global economy, there is no shortage of short-term causes for concern:

1. Continued questions on the sustainability and speed of economic recovery in the United States and Europe and the risk of country specific financial risk.

2. U.S. housing prices that continue to fall and unemployment rates in North America and Europe that are stubbornly high.

3. A surge in oil prices and other commodities in response to stronger global economic conditions

4. A pickup in trade frictions between the U.S. and China to include fears of a political feud over currency manipulation.

The good news is that there are offsetting positives, even if the media headlines that feature them aren't quite as prominent:

1. On Monday March 22nd, the Wall Street Journal ran a story about dividend hikes as a result of rising profits of U.S. companies. The article also mentioned that cash on U.S. corporate balance sheets was at the highest level since 2007.

2. The same day the Financial Times ran a similar story about dividend increases in Europe.

3. There is growing attention to the impact that Germany's emphasis on manufacturing productivity had in sheltering it from the worst of the economic downturn – and questions about whether this might be a model for other countries. In March the Economist ran a 14 page feature on how Germany positioned itself for success.

4. During the first quarter the economy added 1.1 million new jobs according to the household employment survey.

5. Measures of business activity (ISM) suggest that growth in both the manufacturing and non manufacturing sectors are consistent with an economic growth rate of 5-6%, not unusual given the depth of the economic decline.

Whether you choose to focus on the positives or the negatives, there is broad agreement that the steps taken by governments aborted the financial crisis that we were facing a year ago – and there is almost no talk of a global depression. So the issue is not whether the global economy will recover, but when and at what rate – and whether there might be another stumble along the way.

We prefer to think of the current environment as being the equivalent of the upside in an economic cycle; there are still many positive economic events ahead of us to buoy stock market returns. The Federal Reserve will remain accommodative due to the high levels of unemployment—a good thing for expanding business activity. The Administration still has plenty of fiscal stimulus left and a Democratic Congress is not likely to tighten the purse strings when housing is still on the ropes. The turmoil in Europe has benefited the dollar to the detriment of the Euro and speculators who were short the dollar received their comeuppance. We must be also sensitive to the November mid-term elections where a change in the politics of Washington could have an important effect on financial markets.

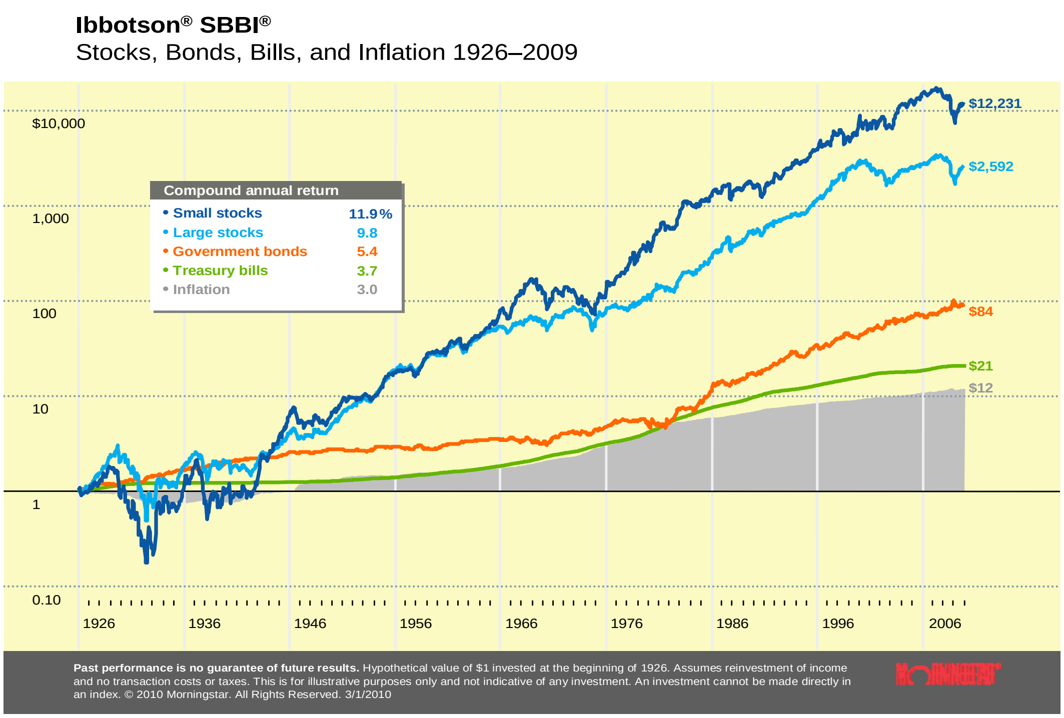
The Investment Outlook

In an environment where the stock market is coming back to life, individual investors receive investment advice through newspapers or television programs. One after another, the gurus tend to focus on what stocks will do well in the immediate period ahead … this week, this month, this quarter. When it comes to short-term predictions, whether about the economy or the stock market, there's one thing we can say with virtual certainty: Most of them will be wrong. As we have said before, no one has a consistent track record of successfully forecasting short-term movements in the economy and markets.

Our theme-based approach is structured for a long-term outlook and is based on the historical returns of different asset classes. The idea is relatively straightforward: In a free economy that is driven by incentives and rewards, individuals will seek out opportunities to create wealth. Companies will be formed, management will finance operations through the issuance of common stock and investors will expect to see the company succeed followed by either rising stock prices or dividends or a combination of both to justify that initial investment. Many years ago we tracked a long-term investment in the common stock of Coca Cola. The owner's dividend exceeded the purchase price of the stock—more than a 100% return on investment each year!

This principle has provided superior long-term returns for investors. The following Exhibit #1 provides evidence of these superior returns since 1926. The higher the return, the higher the volatility but a commitment to long-term investing provided attractive returns. (The graph tracks the investment of $1.00 in 1926. For example, by 2009, that dollar grew to $2,592 if invested in large stocks or to $21 if invested in Treasury bills).

Exhibit #1

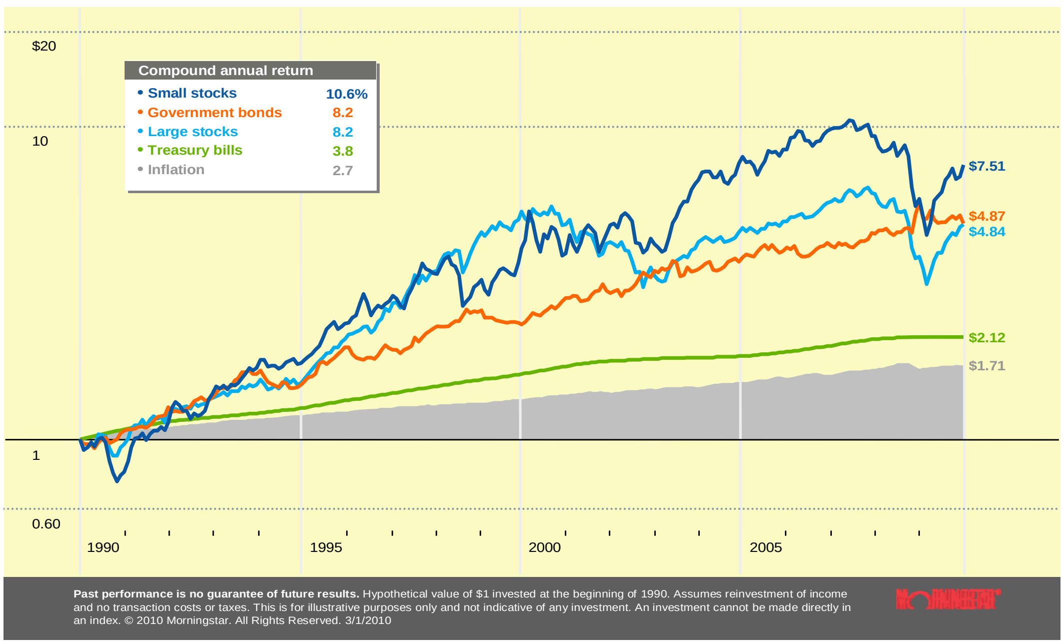


Courtesy of Morningstar, Inc.

For the vast majority of investors, this time period is too long. Shorter time periods make more sense especially if we were to look at the last thirty years of investments in financial markets. In such an environment (from 1990 through 2009) we have experienced three wars, the collapse of two market bubbles -- one related to technology and one related to financial markets. Over the past thirty years investment returns were slightly different but not dramatically. Exhibit #2 depicts the double-digit returns of small cap stocks while government bonds moved up in the rankings with a respectable 8.2% return. However, Treasury bills were still a poor investment.

Exhibit #2

Ibbotson® SBBI®
Stocks, Bonds, Bills, and Inflation 1990–2009



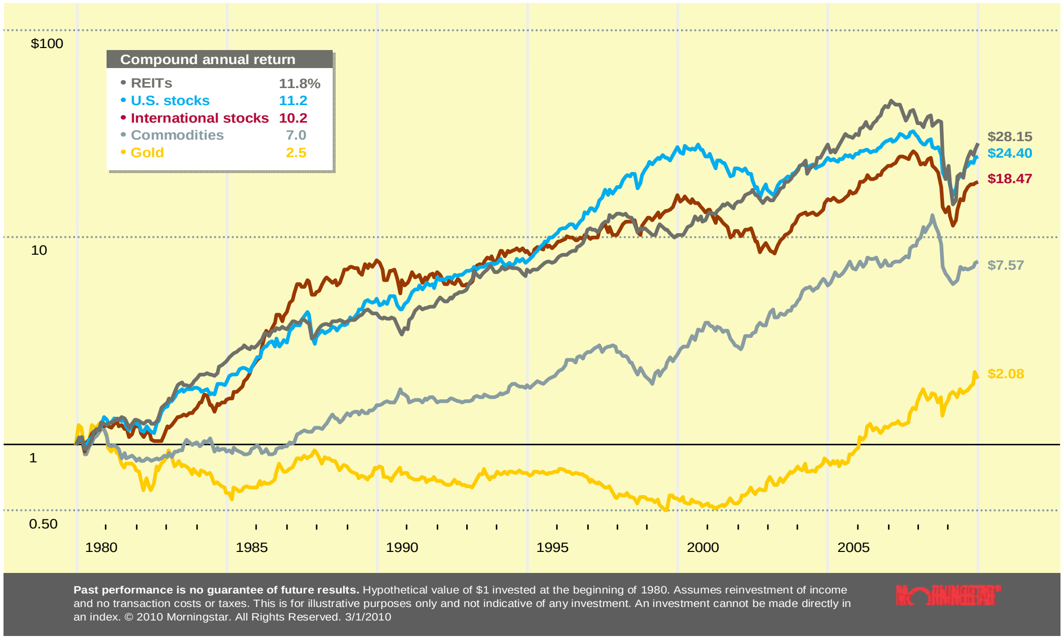
Courtesy of Morningstar, Inc.

Over this shorter time period, the progress toward building wealth was not smooth and investors could have lost money by investing during euphoric highs in 2000 or in 2007 after substantial market advances. Earning positive returns for these investors may entail even longer holding periods. At the end of 2009 stocks appeared to be fairly valued given the historic range of returns since 1990.

How do stocks stack up against other investments? One important factor in making this assessment is the time period over which comparisons are made. One source of research, Morningstar Inc., selected the last forty years to compare both financial and real assets. Exhibit #3 gives us a picture of returns for both stocks and real assets. Over these thirty years, real estate investment trusts (REITs) provided the highest annual compound return of 11.8% while the two lowest returns were gold at an annual return of only 2.5% and commodities, in general, at an annual rate of 7.0%. U.S. stocks came in a close second to REITs at 11.2% followed by international stocks of 10.2%.

Exhibit #3

Stocks, Commodities, REITs, and Gold
1980–2009



Courtesy of Morningstar, Inc.

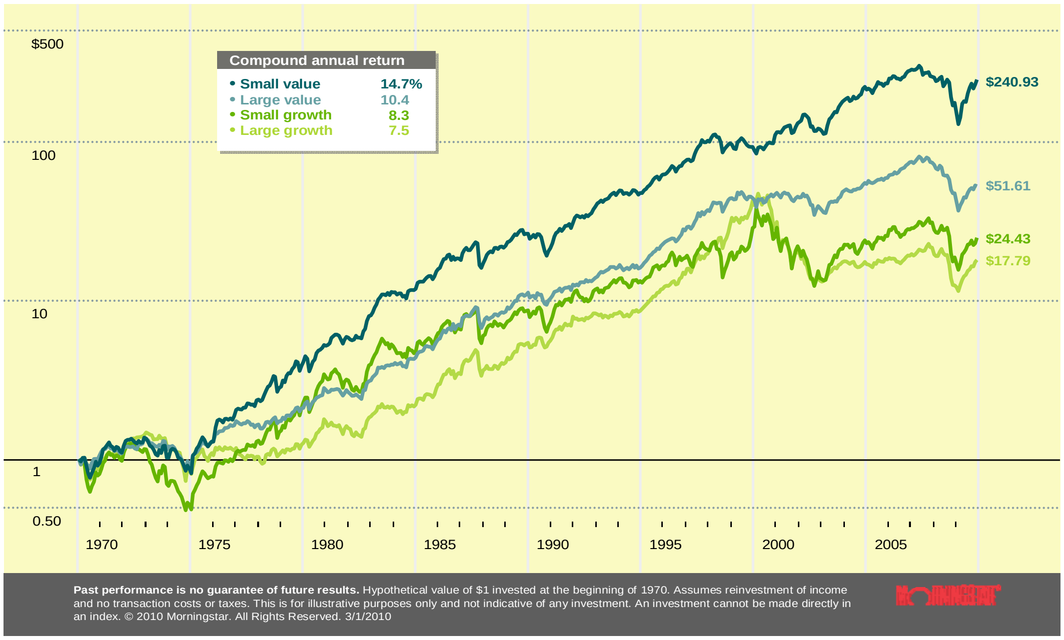
The difference in these compound annual returns becomes more meaningful when converted to an initial investment of $1.00 in 1980. The exhibit reflects that the dollar would rise to $24.40 if invested in U.S. common stocks but only $2.08 if invested in gold. (All those TV ads arguing for gold investments may have some merit but not on an historical return basis.)

Is investing in stocks alone good enough or is there further work to be done? The financial architects have made an effort to slice up equity markets into various pieces. Two generally accepted divisions are growth vs. value stocks and small vs. large capitalization stocks. Once again we can look at the historical returns of these classifications over the past forty years.

Exhibit #4 shows that investing according to classification can also make an important difference in portfolio returns. For example, a portfolio of small capitalization value stocks would have produced annual returns over this period of an impressive 14.7% while a similar investment in large cap growth stocks returned only 7.5%, about half as much. In terms of a dollar invested in 1970, an investment in small cap value produced $240.93 vs. $17.79 in large cap growth stocks.

Exhibit #4

Growth and Value Investing
1970–2009

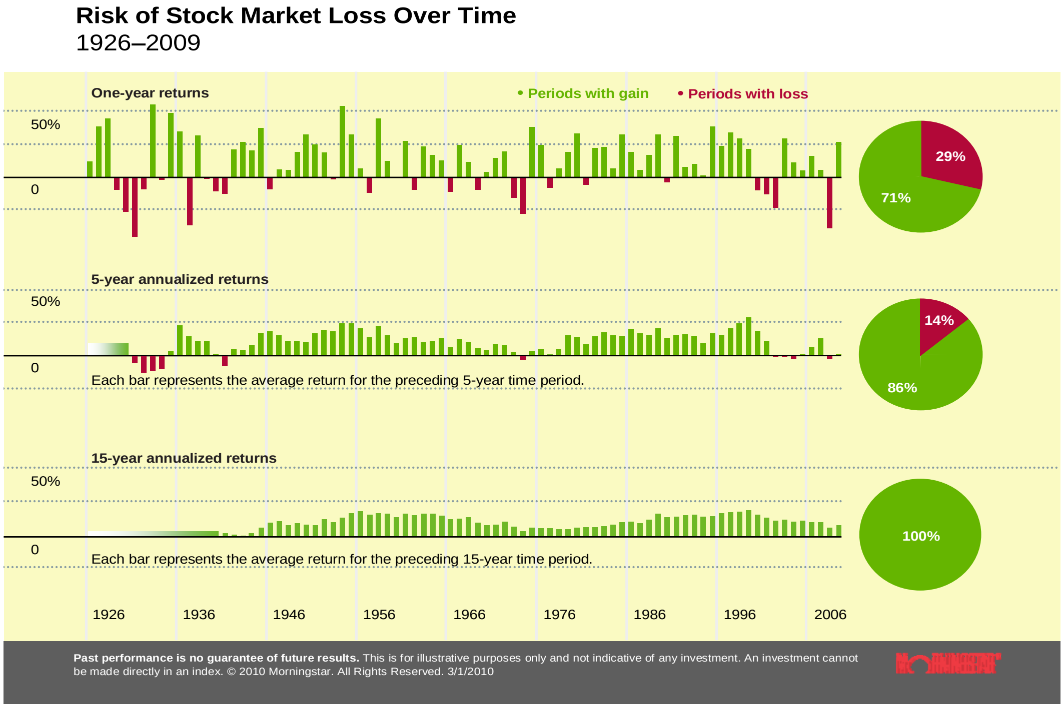


Courtesy of Morningstar, Inc.

The media has emphasized the riskiness of investing in common stocks especially after the recent experience where investors lost all of their money when invested in one or more financial securities. As a result, many investors fled the stock market in late 2008 and early 2009 at or near the bear market lows of this market cycle. For long-term investors, the probability of losing money becomes paramount because saving over a lifetime is a "one-time" event; you don't get a second chance. Therefore we should step back and look at the probabilities or chances of losing money for long-term investors holding diversified portfolios of common stocks.

Exhibit #5 provides a long-term view of investment risk for investors with varying investment timeframes. Note that for all 15 year time periods, investment returns were positive. For five year periods, the chance of losing money was 14% with the bulk of those losses concentrated in the depression years. Of course history is not a guarantee of future results but we can have a reasonable degree of confidence that financial markets will behave positively for long-term investors.

Exhibit #5



Courtesy of Morningstar, Inc.

Conclusion

If we were to put a number on our level of confidence, we would say that the financial and economic problems experienced during the past two years are 90% resolved. After major turmoil, resolution can produce better than expected results. The global stock market surge over the past twelve months attests to a viable recovery from the most recent crisis. In an historical context, stock investors should be well-positioned to benefit from a global business cycle recovery. The challenge will be to identify those investments that can benefit the most from that environment.

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