

On the Lookout For Recovery

It's out there somewhere. The good news, that is. To find it, U.S. Trust picked the brains of three prominent portfolio managers specialized in sectors that often lead in a recovery. **Maria Negrete-Gruson** runs Artisan Emerging Markets Fund. **Mark Garfinkel** co-helms the Perimeter U.S. Small Cap Growth Fund. And **Greg Hopper** manages the Artio Global High Income Fund.

U.S. TRUST: Thank you all for joining us today. We'd like to start off with what each of you foresees for your particular investment focus over the coming 18 months. Maria?

MARIA NEGRETE-GRUSON: Over shorter periods, emerging markets (EM) are tricky to forecast. We don't know exactly when a sustained rally will occur, but we do think these markets are an even more integral part of the global economy than ever before.

How is the emerging markets consumer faring in all of this?

NEGRETE-GRUSON: While we have to acknowledge that EM household incomes have been hit by the global crisis, long-term trends such as urbanization and the emergence of a middle class will support growth in consumer demand. One powerful trend we have observed is the development of private education companies in both Asia and Latin America. People in these countries recognize that education is the way to a better future. Families will sacrifice to provide that potential for their children, even during tough economic times.

Candidly, we believe it will take time before we see the levels of GDP growth in EM that we saw in the boom leading up to the current crisis. We aren't expecting huge growth over the next five years, but even annual GDP growth of 5% to 6% in EM will be significantly higher than that of developed markets.

One of the exciting aspects about EM today is the potential opportunity set,

which we believe is broader today than it was even five years ago. So, we are able to find more companies that have sound business models and better balance sheets that should be able to withstand shocks better than others. That is why we use a bottom-up stock selection approach.

What are you focusing on right now?

NEGRETE-GRUSON: Last year's bear market was particularly punishing for smaller, less-well-known companies, which has resulted in extremely attractive valuations. Although many of these companies



MARIA NEGRETE-GRUSON

would not be immediately recognizable to people outside our profession, we believe they could have potential over the next several years.

Mark, how are small cap stocks performing?

MARK GARFINKEL: If you look at all the bear markets and recession/depression environments over the 20th century, small cap stocks have led the move down. But once there is what might be deemed a bear market bottom, small caps tend to outperform large caps. Now, we may have seen a bottom back in November 2008. But the Russell 2000 Index of small cap stocks is only slightly ahead of the broader S&P 500 Index, far less than what we would normally see in similar circumstances.

So what's going on here is that there has been small cap outperformance, but it's concentrated in the nonfinancial sectors of the Russell 2000 Index. For instance, the Russell 2000 Growth, which is comprised of only 5% financials, was down 9.7% through the first three months of 2009, versus the S&P 500's 11% decline. Meanwhile, all those small financials and banks have held back the broader small cap index, as well as the Russell 2000



MARK GARFINKEL

Value Index (which was down 19.6%), where the weighting of small financials is much larger. More recently, financial stocks appear to be acting better, which could be another positive sign for small caps and the overall market.

Can you give us some background on why small caps tend to lead on the way down and the way back up?

GARFINKEL: Sure. Small caps are generally regarded as riskier assets. They are subject to liquidity issues. When the market is in freefall, liquidity dries up and there are few buyers of smaller stocks. But once you reach a bottom and liquidity returns, risk aversion dissipates and those stocks can snap back. Typically, the riskier the asset class, the faster the snapback. Recently, of course, we've seen a lot of liquidity being pumped into the system, which is a big positive and is being reflected in recent market action, since the early March lows.

Also, the United States is expected to recover first. And most small caps are U.S. plays.

GARFINKEL: That would be a part of it. U.S. consumers started getting hurt before all the others. So it would stand to reason that our economy would return sooner, in general. Keep in mind, though, that from a fundamental and earnings growth perspective, 2009 is going to be a very difficult year for all companies, whether small, mid or large cap. However, earnings growth, while negative, should trough for most companies at some point this year.

Greg, high yield also typically recovers in the early part of the cycle. Why is that?

GREG HOPPER: That was certainly the case in the 1989-90 downturn. High yield declined about 18% going into that recession, then rallied about 30% coming out of it. Over the following four years, high yield returned about 50% cumulatively. Something similar happened during the



GREG HOPPER



tech bubble and its aftermath.

One reason for this is that high yield usually overreacts to a downturn. And then high yield bonds end up being a fulcrum security in a recovery. They are the securities that are on the cusp. If we go farther into a recession, default rates start skyrocketing and high yield goes over a cliff. But if we recover, at the end of the day these are leveraged securities.

There is also a liquidity premium and discount to high yield. It gets to be a relatively illiquid asset class in bad times. And as people gain confidence and more liquidity enters the markets, just as with small caps, the markets that have been suffering the most from the liquidity discount, including high yield, tend to bounce back more.

Maria, earlier you mentioned the emergence of a middle class in the emerging markets. How much of that has transpired?

NEGRETE-GRUSON: We have seen that happen in Mexico and elsewhere. The first catalyst is typically a stabilization of economic conditions. Interest rates decline and mortgages become more accessible to more people. Owning a home gives people an opportunity to put their savings into a long-term investment. They will likely go on to buy

a refrigerator, keep a child in school and so on. It's the multiplier effect.

It's a slow process, though. In Brazil, for example, interest rates have never been low enough. And in Turkey and China a lot of the real estate expansion has been concentrated on the high end, which is not sustainable. While it is a challenge to make lower-income housing profitable, more and more resources are being put towards it. Though the current credit market environment has limited the near-term growth prospects, the evolution will continue once markets are more stable.

With regard to small caps, Mark, what areas are you emphasizing and de-emphasizing?

GARFINKEL: As always, we make selections on the basis of our three primary pillars. Briefly, first, we look for positive return characteristics with a strong likelihood of outperformance going forward. Next, we apply our experience to focus our research. We narrow down the list to those companies we really want to focus on. Lastly, we implement our bottom-up research. What's going to drive the business fundamentals? What's going to drive stock performance? Will the company generate long-term shareholder wealth? And so on.

For instance, history tells us that consumer discretionary and tech usually lead out of bear market bottoms. So we'll pay a lot more attention to those areas, when looking for signs of earnings improvement, rather than, say, industrial companies or materials, where earnings improvement usually lags.

We'd also avoid healthcare, which, going into the downturn was both overvalued and then hit by the credit crisis. Most hospitals had difficulties accessing capital to buy new devices and equipment or to spend on IT systems.

A question for all of you: Where do you see risks?

HOPPER: Overall bond quality is lower in this recession than in previous ones.

I'd also point to political and economic risk. A breakdown in global economic cooperation, for instance, or a devolution to various trade barriers.

GARFINKEL: While we are confident that the economy should improve from the current depressed levels, the question remains how much will it or can it improve, given that the U.S. consumer is still "tapped out" by historical standards and employment trends remain weak. If we begin to see signs that the U.S. consumer won't be able to sustain positive momentum and employment trends do not bottom, we would need to pull back on the offensive nature of how we are positioned for a recovery.


NEGRETE-GRUSON: Right now we're concerned that the global nature of the current recession will be difficult for those companies and countries that have become accustomed to generating growth by exporting to the developed world. With Europe, the U.S. and Japan simultaneously decelerating, it could take awhile before they're ready to absorb all that manufacturing output again. Although we're not thematic about it, we currently believe there are potential opportunities among those companies able to participate in more internal, organic growth within EM.

Thank you all very much for your time. ■

By Ian Prior, U.S. Trust

The information in this article is general in nature and designed to offer a perspective on broad economic or market trends. It is not intended to give you suggestions about your specific portfolio because there is no assurance that investments in these market sectors would be suitable for you in light of your existing portfolio, investment goals, tolerance for risk and other financial-planning considerations. Consult your advisor first to determine if the ideas in this article are relevant to your personal financial circumstances. Opinions expressed in this article are those of the featured participants and may differ from those of U.S. Trust and/or Bank of America Corporation and its affiliates. Bank of America Corporation and its affiliates may have, or may have in the future, investments in funds managed by the featured firms or individuals or their affiliates. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors. Equity securities are subject to stock market fluctuations that occurs in response to economic and business developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop and vice versa. The information and views contained in this magazine as of the date noted are for informational purposes only and do not contend to address the financial objectives, situation or specific needs of any individual investor. The information presented does not constitute, and should not be construed as, any advice or recommendations by U.S. Trust, Bank of America Corporation or any of its affiliates. Moreover, neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any investment or security. Information in this material is not intended to constitute legal, tax, or investment advice. You should consult your legal, tax and financial advisors before making any financial decisions. Forecasts and model results are inherently limited and should not be relied upon as an indicator of future performance.

The information presented in the articles is not necessarily representative of the opinions and views of Bank of America Corporation or any of its affiliates.

U.S. Trust, Bank of America Private Wealth Management operates through Bank of America, N.A. and other subsidiaries of Bank of America Corporation. Bank of America, N.A., Member FDIC. Equal Housing Lender 

©2009 Bank of America Corporation. All rights reserved.

Date of First Use: May 29, 2009.