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Global Market Aftershocks

Like the rest of the world, we are watching the tragic events in Japan intently, with great sympathy for a nation that has seen more than its share of disasters over the years. Events are unfolding rapidly, with the biggest and most volatile source of fear being the release of radiation from the crippled Fukushima Daiichi nuclear plant. So far, most nuclear power experts are downplaying the risk of a catastrophic radiation release. Nevertheless, the horrific human toll and potential damage to the Japanese (and global) economy – on top of already dramatic and troubling political events in the middle east – is contributing to global financial market volatility. At moments like this, it is critical for us as fiduciaries to think clearly and dispassionately about the risks and opportunities that may present themselves, and to take appropriate and well-reasoned action on our clients' behalf.

Uncertainty vs. Risk

As professional investors, we avoid confusing uncertainty with risk - for the distinction is important. Looking past the immediate volatility, the most relevant risk is the potential impact of this event on the global economic recovery. Japan is the world's third-largest economy; a disruption of this scale in the short-term will definitely impact overall global economic activity. Despite the grim network news accounts, however, there is a considerable part of the economy intact and doing "business as usual". Then there is the possibility that rebuilding activity in Japan may actually serve to foster a recovery. Japanese finances are already stretched, with sovereign debt equivalent to about 200% of GDP. The need to raise massive funds for reconstruction may be just the catalyst to fuel Japanese inflation, which, despite the negative impact on the significant older population, would actually stimulate consumption and growth.

Defensively Postured

Uncertainty is very high at the moment, but we have positioned our portfolios to withstand – at least on relative terms – such volatility. We have made a conscious effort to communicate with clients about short-term versus longer-term risks, and structured portfolios to address those risks. Typically we are fully invested, though we have been holding somewhat more cash than usual, particularly in bond portfolios. With cash on hand to meet ongoing liquidity needs, our clients don't need to sell into the current distress. Some defensive attributes can also be found in the many highly liquid and conservatively valued holdings in our portfolios. These securities, like cash, can be used as a source of funds to establish positions that are likely to perform relatively well as the market turns from avoiding risk to favoring it.

Swift Market Reaction

Markets can be cruelly dispassionate yet ruthlessly efficient in reacting to "black swan" events. Asset classes across the globe, including commodities, have declined precipitously, quickly pricing in a significant economic disruption. By some accounts, Japanese equity valuations are at their lowest since 1993. The most direct connection of this event to our markets is through Japan's role as one of our major creditors. Japan is a major supplier of auto parts and other industrial goods, whose economy has remained export-driven. Since trade surpluses find their way back in some measure into our treasury market, a meaningful diversion of these

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funds toward domestic rebuilding could put incremental upward pressure on U.S. bond yields.

Rising Risk Premiums Create Opportunity

While we cannot predict the eventual market reaction or economic impact, history has demonstrated that the cataclysmic predictions issued in the heat of the moment are often unrealized. This is not a threat to the global financial system such as we saw in 2008, and we believe the long term impact on global growth will not be significant. Yet the markets have reacted violently, and risk premiums (the additional return on "risky assets" provided by lower prices) are rising, creating opportunities. The challenge is achieving the delicate balance of acting deliberately enough to exploit asset class mispricings, while not acting too hastily as a fluid situation unfolds.

We are considering appropriate actions with asset classes and securities we know well, and are examining suitable strategies for obtaining direct exposure to depressed Japanese equities. A critical element in the past two years' resurgence of the equity markets has been the unyielding effort of global central banks to supply liquidity to a halting economic recovery in developed countries. Although this policy would probably have remained unchanged in the absence of this event, a continuation of an accommodative Fed policy now seems to be a foregone conclusion. We therefore expect the yield curve to stay steep or steepen further, and are limiting fixed income allocations and keeping bond durations short.

The recent cascade of global events, culminating with the shocking devastation in Japan, is unsettling to say the least. While we recognize these events are beyond our control, we firmly believe in the resiliency of the global capital markets. As always, we will continue to monitor the evolving situation closely, and encourage clients to reach out to their portfolio manager with any questions or concerns.