

Investment Update: The Summer of Our Discontent

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Ordinarily, it's pretty quiet on Wall Street this time of the year, as many investment professionals take the opportunity to spend their summer vacations in the Hamptons. But this isn't an ordinary year. Houses in the Hamptons can be rented by the month instead of by the season, and many of those houses are sitting vacant, waiting to be sold. The economic and market environments certainly haven't lent themselves to a relaxing vacation for anyone.

Bad news seems to be everywhere these days, affecting a majority of the drivers of economic growth. The housing market remains mired in the price collapse that took place a couple of years ago, and it has a long way to go towards recovery. Recently, the National Association of Home Builders confidence index declined to the lowest level since August 2009, and housing starts were the lowest they had been since October 2009. In the labor market, jobs are still hard to come by for many Americans, as unemployment hovers just below double digits. Initial jobless claims were higher than expected last week and have remained elevated for the past few weeks.

The continued negativity in all of these areas has spilled over to the consumer as well. The Conference Board announced that consumer confidence fell for the second consecutive month in July, with consumers' expectations looking much worse for the near future. Again, this is not a scenario where financial professionals or investors can plan on having a restful vacation.

The gloom and doom of the consumer is also reflected in our current political atmosphere. The turmoil in the markets from the credit crisis sparked citizen outrage, as U.S. taxpayers were compelled to bail out major players in industries such as banking and autos, even as they themselves were under water on their mortgages and in danger of losing their jobs. This anger is currently being directed at Congressional leaders who orchestrated these bail-outs, and change in leadership is expected when voters go to the polls in November.

In the corporate sector, money remains on the sidelines as firms neither invest nor hire. If you add in the uncertainties surrounding the European sovereign debt crisis, the general lack of confidence takes on a global flavor.

In the meantime, fears of a double-dip recession and the murkiness of what may or may not come to pass has created volatility in the financial markets, where prices will soar in the morning only to plummet in the afternoon. It's a gloomy scenario.

So, what's an investor to do?

Our View

Solid companies are trading at reasonable valuation levels. The European sovereign debt crisis is looking less dire, and the "stress tests" conducted on banks in Europe were largely positive. Corporate earnings have been mostly positive during the earnings season so far, and exports seem to be gaining traction worldwide. In short, the news isn't all bad.

Despite these encouraging signs, a significant amount of cash is sitting on the sidelines as individual investors remain wary, waiting for more clarity before committing additional funds. In stark contrast, institutional investors are investing in stocks. A Citigroup survey shows that institutional investors took the percentage of equities in their portfolios up to 68% in June from 63% in April. June's numbers represent the highest weighting institutions have given to equities in the past 15 months.

In our view, institutions are making the right move by taking action based directly on their investment objectives. These entities have long-term time horizons and are betting that the economy will recover over time. While range-bound trading may continue, at least through year end, in the current market environment, we believe the longer-term trend will be upward.

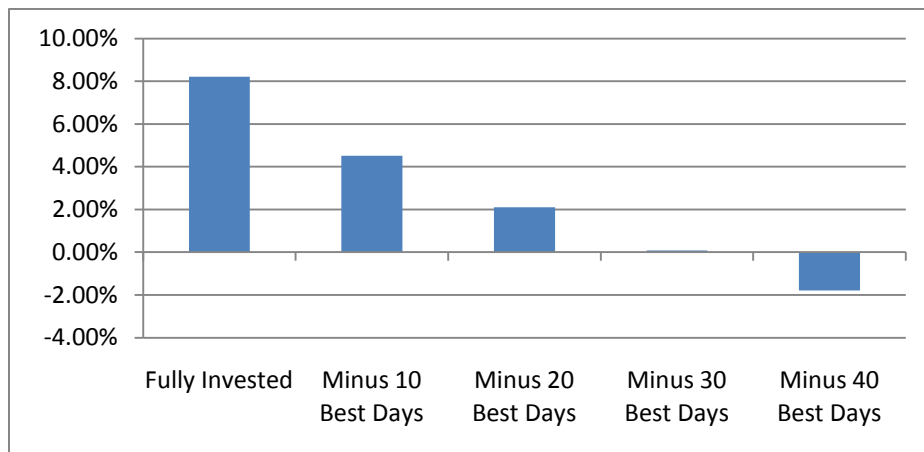
For investors with shorter time horizons, we like bonds over stocks through the end of the year. Within bonds, we expect high-yield and emerging market debt to continue to set the pace. In equities, we favor large-cap stocks over small caps. In the longer term, we expect markets to revert to the mean with equities outperforming bonds.

Regardless of time horizon or point of view, we believe the worst thing investors can do at this juncture is take no action. This is not the time to keep your head in the sand. Instead, we recommend taking

this time to reevaluate your goals and risk tolerance, making sure that your portfolio reflects your objectives. While market movements are difficult to predict, there are a number of potential catalysts that could point to a more positive direction. Missing that move could be costly, as shown in Exhibit 1.

Exhibit 1: A Few Days Can Make a Big Difference

(S&P 500 Index Returns, January 1990-December 2009)



Source: SEI, FactSet.

Using the S&P 500 as a proxy for the domestic equity market, if an investor missed just ten days during a 20-year period, half of the profits would be lost. Missing 20 days took away three quarters of the profit. Missing thirty days reduced the profit to just 0.8%, and missing 40 days resulted in a loss. When you don't make a choice, you are still making a choice.

At SEI, we believe in active management and proactive planning. While financial markets are cyclical, planning should be continuous. The current negative atmosphere won't last forever. Look ahead and plan accordingly.

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