



Investment Outlook:

*Searching for Opportunity
Amid a Sea of Uncertainty*

A Defensive Tack Remains Warranted

November 11, 2011

Investment Climate

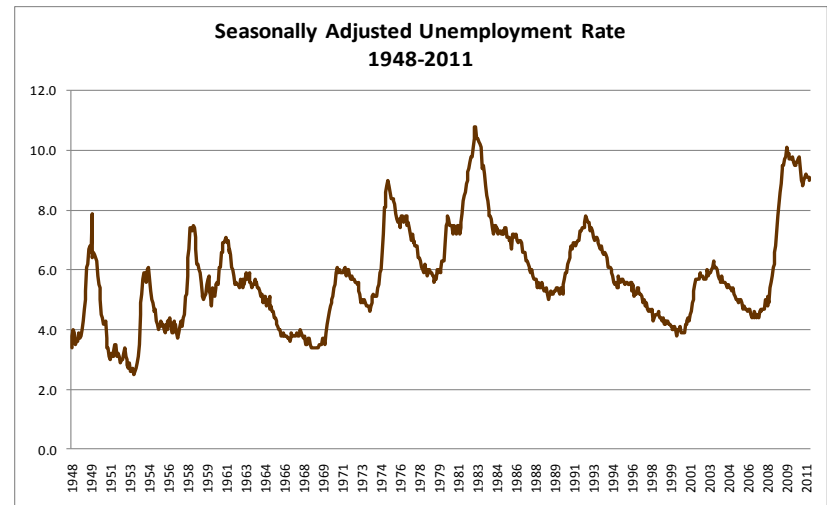


- US economy remains challenged
 - Likely to remain so for an extended period of time
 - Too much debt
 - No quick fixes
- US Real Estate remains a drag
- European risks at the forefront
- Financials Back in the ‘Spotlight’
- Cautious on China
- Inflation or Deflation
 - Where do we go from here?
- Stocks remain the “Best House in a Bad Neighborhood”
 - Defensive posture remains warranted
 - Opportunities *do* exist

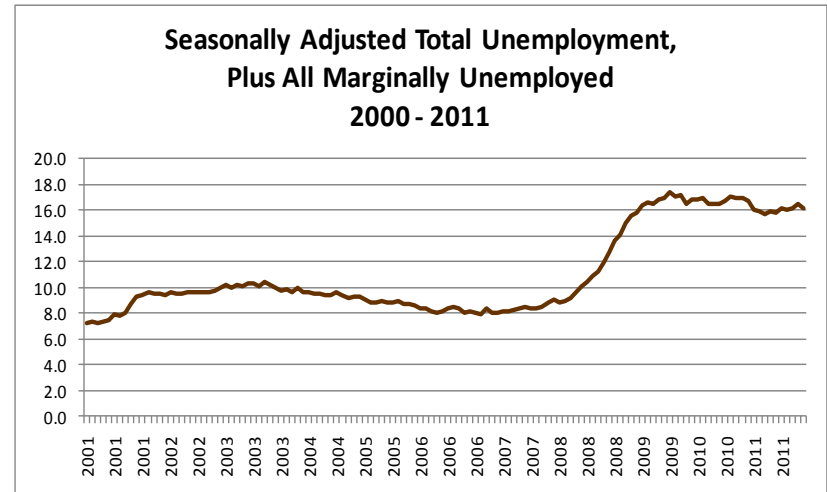
Unemployment: Improvement Muted



- Nonfarm payrolls rose by 80,000 in October, below expectations¹
- Government employment continues to trend down, with 24,000 jobs lost
- The unemployment rate declined slightly to 9.0% from 9.1%¹
 - U-6 declined to 16.2% from 16.5%
- Those unemployed for 27 weeks or more continues to remain elevated at 5.9 million, representing 42.4% of the unemployed¹
- Post recession unemployment remains stubbornly high
 - At its current pace of job creation, it will take until the end of 2016 for the US to replace all the jobs lost during the recession that ended two years ago²



Source: Bureau of Labor Statistic Data



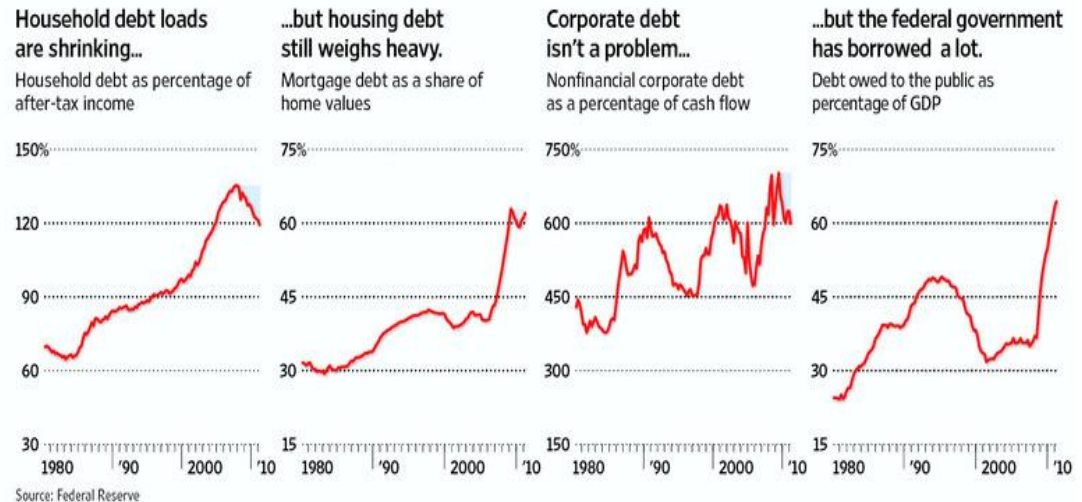
Source: Bureau of Labor Statistic Data

Deleveraging: A Picture is Worth a Thousand Words



- At the peak of the economic boom (Q3'07) US households collectively had borrowed the equivalent of 127% of their annual incomes
 - Up from an average of 84% in the '90s.
- Households worked their debt-to-disposable income levels down to 114.6% by the second quarter¹
 - In order to get back to a ratio of 84% consumers would have to pay down another \$3.3 trillion of debt, or see their incomes rise by \$3.9 trillion
- US consumers have 37% more credit-card, auto and other nonmortgage debt than a decade ago¹
- At \$9.9 trillion, there is more mortgage debt outstanding than there was five years ago¹

How Far Along Is the Great Deleveraging?

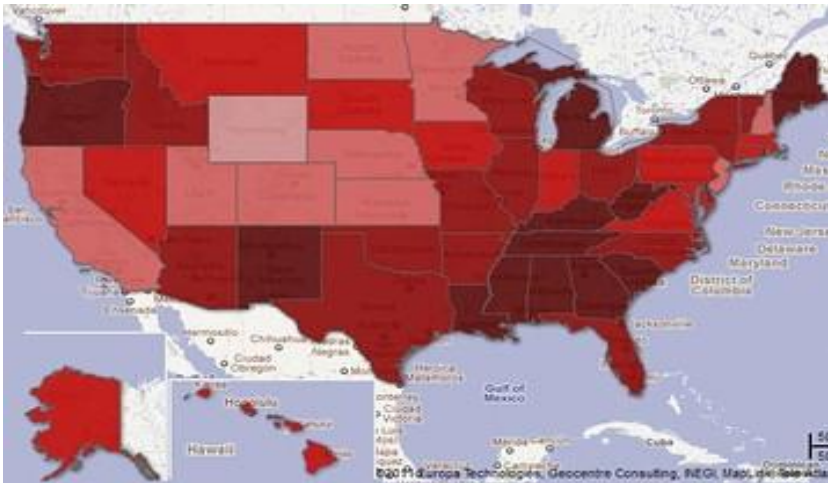


Wall Street Journal 09/08/2011

- According to the IMF, the US government debt-to-GDP ratio will hit 99% this year – up from 62% in 2007
 - Further, the IMF estimates US public debt at 112% of GDP five years from now – even taking into account growth estimates and current proposals for deficit reduction²
 - Additionally, the IMF estimates the US budget deficit will hit 9.9% of GDP in 2011²
 - Second-largest of any of the developed economies

¹The Federal Reserve Bank ²International Monetary Fund

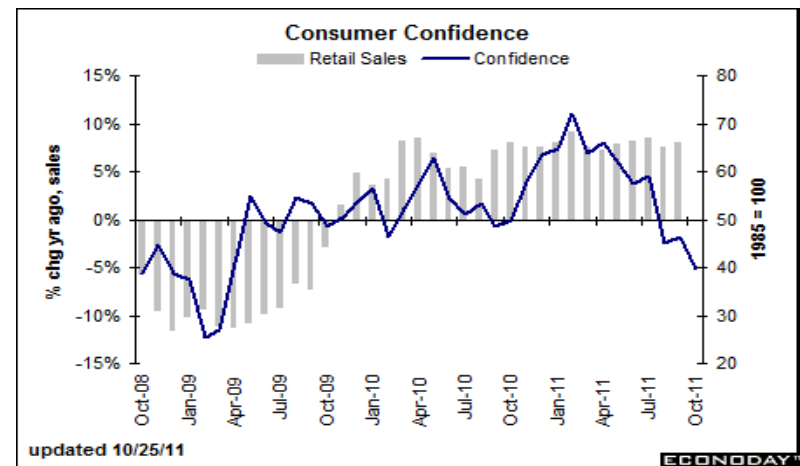
US Consumer Remains Strapped



Wall Street Journal 11/01/2011

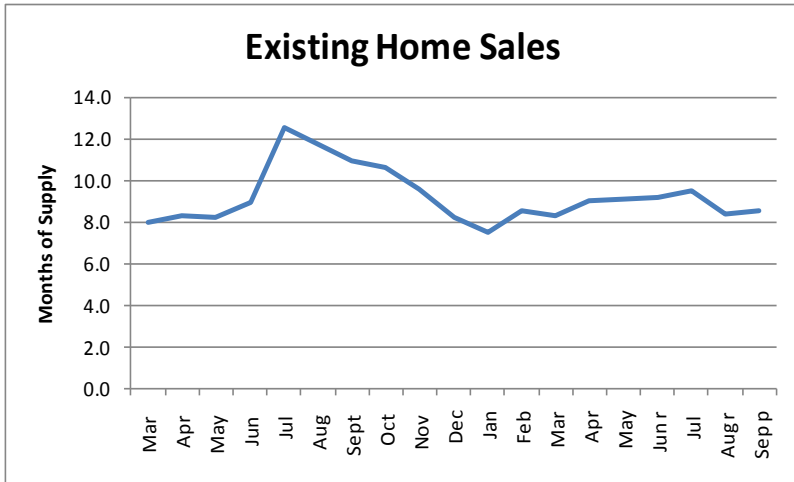
- As of August, nearly 15% of the US population relies on food stamps¹
 - Recipients total 45.8 million
 - A rise of 8.1% in the past year
- At the same time, these benefits are at risk of being cut as Congress mulls ways to cut the federal budget deficit

- The number of Americans below the poverty line hit the highest levels in 35 years – 6.7%²
- Consumer Confidence fell to 39.8 in October, down from 46.4 in September³
 - At similar levels to that seen during the '08-'09 recession



Source: Bloomberg

US Real Estate Remains a Drag



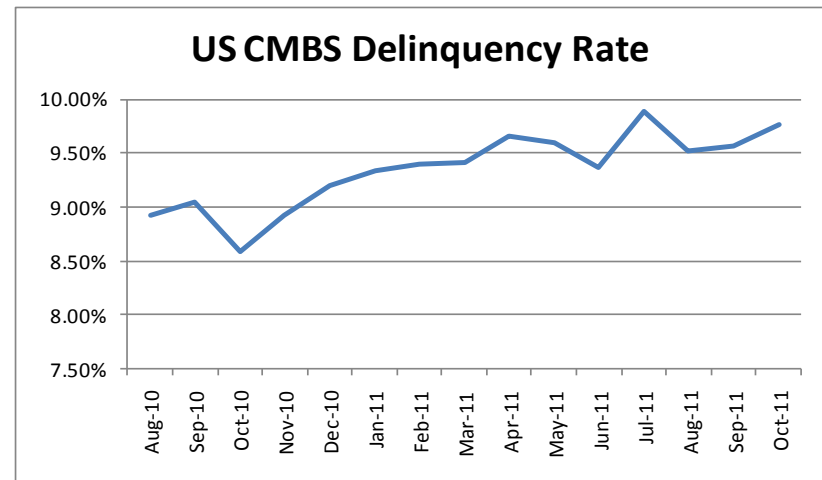
Source: National Association of REALTORS



Source: American Bankruptcy Institute



Source: American Bankruptcy Institute



Source: Trepp, LLC data

European Contagion: Still Spreading



- In the latest effort to prevent a Greek default, in late October, euro zone leaders struck a deal with private banks and insurers for them to accept a 50% loss on their government bonds under a plan to lower Greece's debt burden
 - Losses equate to €100 B¹
 - The insurance written on this Greek debt - otherwise known as credit default swaps - **WILL NOT** cover investor losses generated by the write down²
 - Calls into question the validity of the credit default swap market
 - Risks pushing up borrowing costs for governments, especially in the euro zone
- Italy agrees to permit the IMF to monitor its progress with fiscal reforms; PM Berlusconi resigns - not enough as worries continue
 - Italy's 10-year bond yield rises to record levels³
- French government takes additional austerity measures in order to meet deficit targets (4.5% of GDP) at lower growth levels (1% v. 1.75%)

Bond Yields Before and After the Bailouts

A familiar pattern The yield on Italy's 10-year government bond over the past six months appears to be following a path similar to those of Greece, Ireland and Portugal in the six months preceding each of their initial bailouts.



The aftermath

The yield on Portugal's 10-year government bond slowed its climb after its bailout.

Ireland's yields fell in response to its debt-relief package and austerity measures imposed by its government.

But as Greece struggles to finalize its rescue package, its yields have soared. And doubts about the euro zone's stabilization plan continue to shake its debt markets.



Sources: Thomson Reuters Datastream; ICAAP

Financials Back in the 'Spotlight'



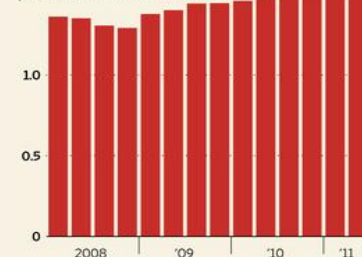
- The collapse of MF Global Holdings has brought financials back in the spotlight
- Prior to filing for bankruptcy, MF was operating at a pre-crisis leverage ratio of 33:1¹
- For comparison purposes, Lehman had a leverage ratio of 31:1 in 2007²
- Has many thinking 'what if we had another financial crisis?'
- Despite increased capital levels at US banks (up 20% since September '08³), the fact is leaders of developed economies, burdened by large government debts, are in a weaker position to address a crisis than in 2008

Financial Fault Lines

U.S. banks are on firmer footing than in 2008...

Total equity capital

\$1.5 trillion



...but bank stocks, U.S. and euro zone, have been on a roller coaster.



Fears are triggering higher costs of insuring against bank defaults...

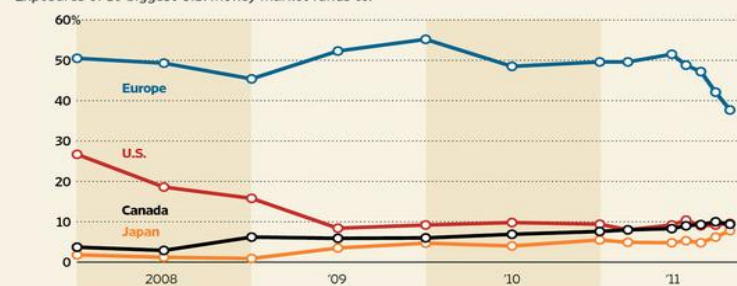
Annual cost to insure \$10 million in debt for five years

\$600,000



...while U.S. money market funds are pulling away from Europe to safer havens.

Exposures of 10 biggest U.S. money market funds to:



¹Based on Markit iTraxx Europe index

Sources: FDIC; FactSet Research Systems; DJ Indexes; Markit; Fitch Ratings

Source: *The Wall Street Journal* 11/03/2011

¹Reuters ²Lehman 2007 Annual Report ³*The Wall Street Journal* 11/3/2011

European Banks: The 'Other' Risk



- Sixteen top European banks are holding about €386B (\$532 B) of potentially suspect credit-market and real-estate assets¹
 - That's more than the €339 billion of Greek, Irish, Italian, Portuguese and Spanish government debt those same banks were holding at the end of last year
- European banks have been slower to shed their legacy assets since 2007 – only cutting them in half as compared to their US counterparts slashing such assets by well over 80%¹
- In addition, European banks have sizeable portfolios of US commercial real-estate loans and subprime mortgages¹

China: Walking the Tight Rope



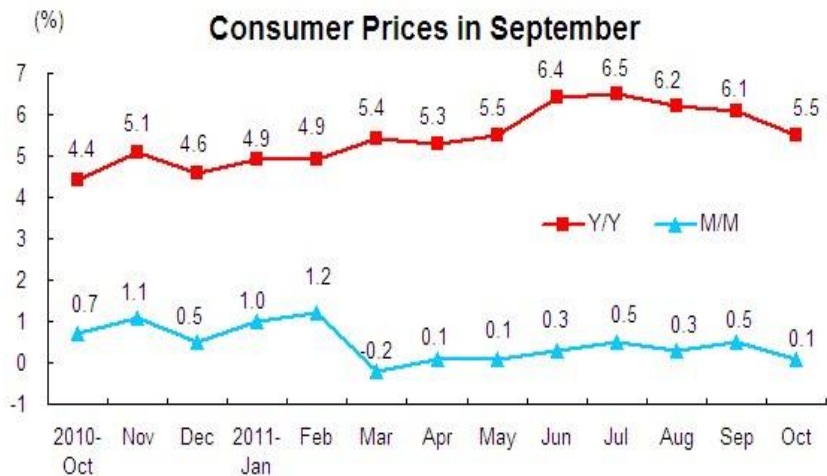
- In an effort to prevent 'overheating' its economy, through the second quarter of 2011, China has increased the reserve requirement ratio six times by 3 percentage points cumulatively
 - Benchmark deposit and loan requirements were raised three times
 - The 1-year deposit rate now stands at 3.50%, while the 1-year benchmark lending rate now stands at 6.56%
- Actions are working, albeit slowly:
 - Q3'11 GDP increased 9.1%, down from the 9.5% and 9.7% seen in Q2 & Q1¹
 - October Manufacturing PMI fell to 50.4 from 51.2 in September¹
 - The gauge of new orders declined to 50.5 from 51.3
 - October home prices fell 0.23% from September²
 - Feeling impact of government restrictions on housing purchases and increased down-payment requirements
 - CPI rose 5.5% in October, down 1% from peak levels in July
 - Food prices rose 11.9%; Pork prices rose 38.9%¹
 - PPI declined 0.7% in October, but rose 5% year-over-year¹
- Wen Jiabao indicated recently that economic policies will be 'finetuned' when necessary³
 - Language was taken to mean Beijing was considering easing some of its cooling measures

China:

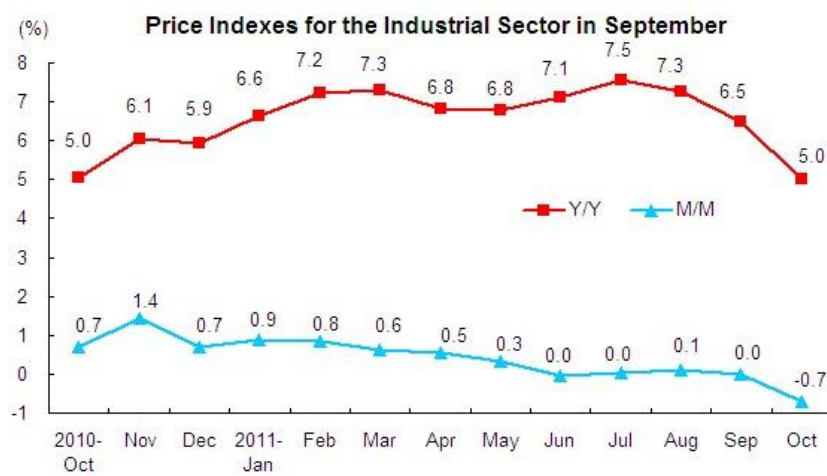
Pictures Speak a Thousand Words



Source: *The Wall Street Journal* 11/08/2011



Source: National Bureau of Statistics of China



Source: National Bureau of Statistics of China

The Fed: Now What?



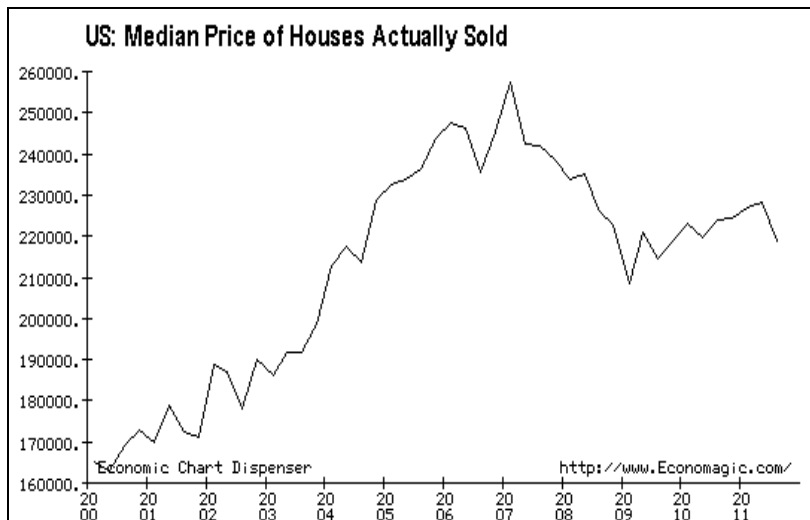
- We anticipate some form of 'QE3' down the road coupled with further expansion of the Fed's balance sheet
 - Speaking to the Bronx Chamber of Commerce in October, NY Federal Reserve President William Dudley indicated that it was "possible that we could do another round of quantitative easing"¹
- We view recent action by the Fed to hold interest rates "near zero until the middle of 2013" as a **first step**
 - Recent testimony by Ben Bernanke indicates rates might stay low for even longer, given the dismal unemployment outlook²
- With limited options under their belt, the Fed recently implemented 'Operation Twist 2.0'
 - A monetary maneuver in which the Fed purchases longer-dated securities and sells shorter ones in an attempt to lower long-term invest rates
 - A similar program, Operation Twist, was attempted by the Fed in the early '60s³

Inflation or Deflation?

It Depends

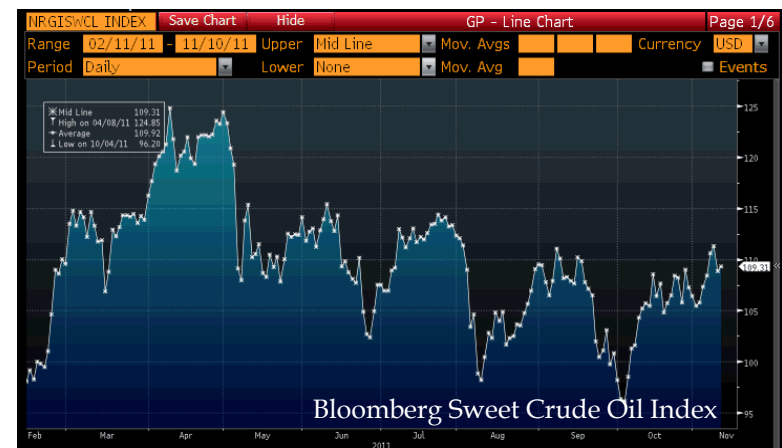


- In areas where assets are tied to debt, in particular housing, we believe there will be continued *deflation*



Source: www.economagic.com

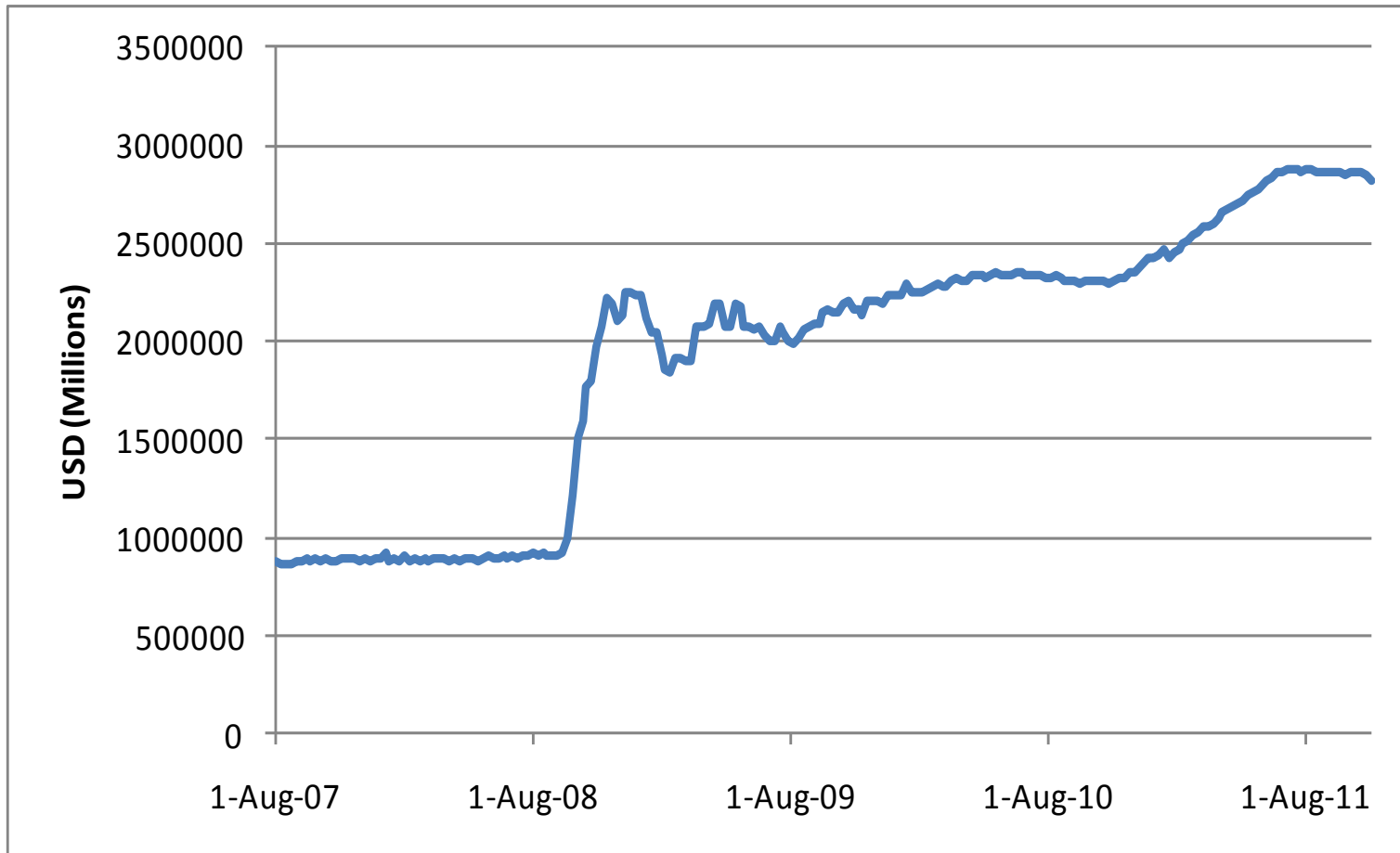
- In areas where assets are *not* tied to debt, such as food and oil, we believe there will be periods of *inflation*



Fed Balance Sheet



Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown in size and has changed in composition. Total assets of the Federal Reserve have increased significantly from \$869 billion on August 8, 2007, to well over \$2 trillion.



Source: The Federal Reserve Bank

Equities:

Remain The Best House in a Bad Neighborhood



❑ Cash

- ❑ Schwab's Money Market Fund (SWMXX) yields a paltry 0.01%¹
- ❑ Bank of New York Mellon announced it will charge large clients to hold cash²

❑ Bonds

- ❑ 2-Year AAA Corporates Yield 0.71%³
- ❑ 2-Year AAA Municipals Yield 0.40%³
- ❑ Average Junk Bond Yields are at 8.543%⁴, well below 2008 peak levels of over 21%⁴
- ❑ 10-year Treasury Yields 2.04%⁵

❑ Real Estate

- ❑ Prices Remain Depressed
- ❑ Inventory Remains High
- ❑ Foreclosures/Delinquencies Remain a Concern

✓ Stocks

- ✓ Compelling Valuations
- ✓ Large Overall Cash Position
- ✓ Attractive Dividend Yields
- ✓ Tend to Perform Well During Inflationary Periods

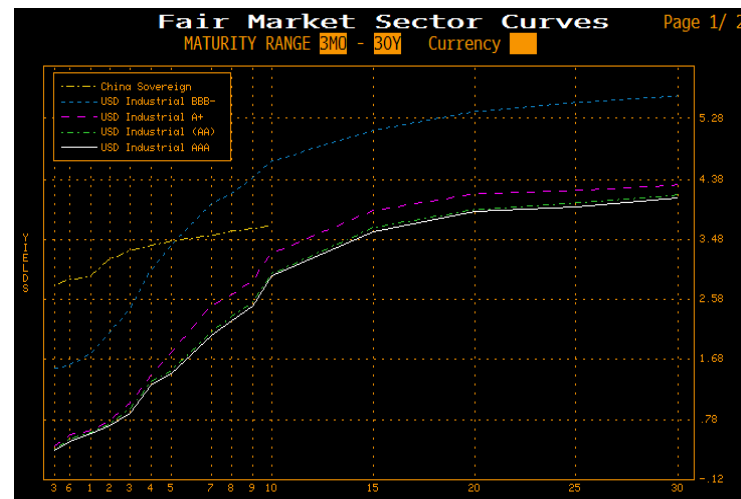
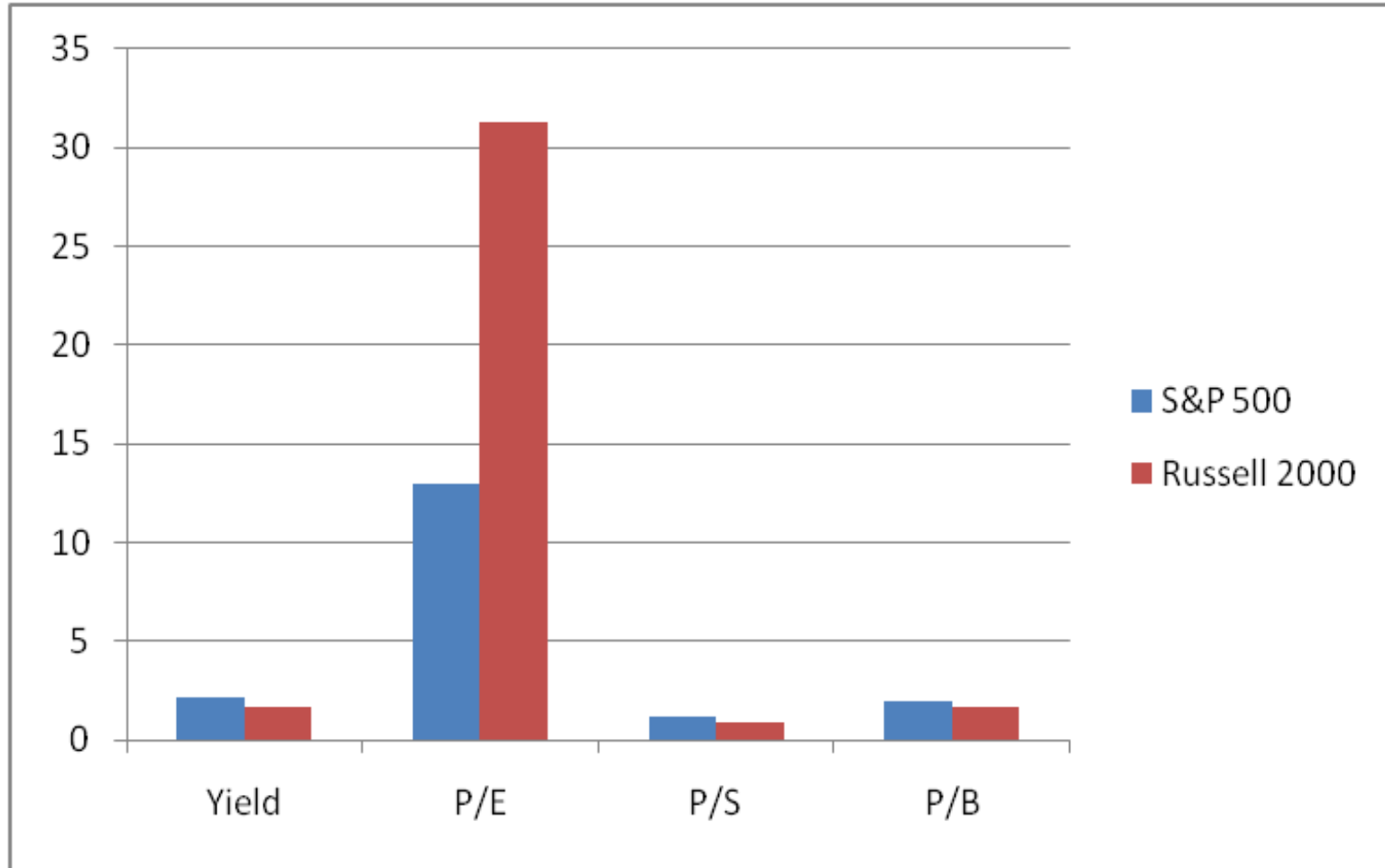


Chart Courtesy of Bloomberg 11/10/2011

We Prefer Large Caps



Dividends v. Debt



- In the month of October, there were 140 dividend increases, an increase of 17.7% over the number of increases seen in the same period last year¹
- The yield on the S&P 500 Index is higher than that of the 10-year Treasury - representing only the second period since the 1950s in which that was the case²

<u>Company</u>	<u>Annual Dividend</u>	<u>Dividend Yield</u>	<u>Similar Bond</u>	
			<u>Yield</u>	<u>Coupon/Maturity</u>
Abbott Laboratories	\$1.92	3.50%	2.672%	4 1/8% <u>Due 05/27/20</u>
Campbell Soup	\$1.16	3.40%	3.381%	8 7/8% <u>Due 05/01/21</u>
Johnson & Johnson	\$2.28	3.50%	3.693%	6.95% <u>Due 09/01/29</u>
Statoil	\$0.94	3.50%	3.481%	6 1/2% <u>Due 06/07/21</u>
Total	\$1.37	2.60%	3.431%	4.339% <u>Due 07/07/21</u>
Vodafone	\$1.92	6.70%	4.396%	6.15% <u>Due 02/27/37</u>

Data Courtesy of Bloomberg

¹Standard & Poor's monthly dividend action report (based on common listed on the ASE, NYSE, NGM, NNM and NSC. ²Bloomberg

Selectivity is Key



- Emphasis On:
 - Attractive Valuations
 - Companies with Pricing Power
 - Exposure to Emerging Markets
 - Compelling Dividend Yields

- Shy Away From:
 - Excessive valuations
 - Names that rely solely on US and European markets for growth
 - Companies that lack Pricing Power

Thematic Filters



Expect period of tepid economic activity



Erosion of the middle class of developed nations



Expanding middle class in Asia and Africa



Positioned for Rising Inflation/Interest Rates *Overtime*



US dollar will be in a long-term decline
(interrupted by sharp rallies)

Investment Approach



FIXED INCOME

- Continue to keep WAM relatively short as we focus on slightly lower quality issues in order to enhance yield → Do not rely on ratings agencies
 - Fed actions “green light” to extend maturities slightly
 - Stay ahead of major debt distributions

EQUITIES

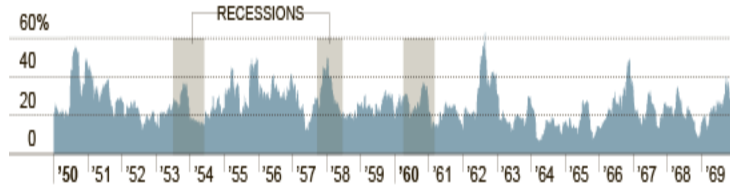
- Stock Pickers Market – Opportunities Exist
 - Keen eye on Valuations; Selectivity is key
 - **Increasingly** favor strong dividend payers over paltry bond yields
 - Companies in the S&P 500 index were holding \$2.77 trillion in cash and short-term investments in the second quarter
 - Taking a defensive stance
 - Focus on Foods, Beverages, Pharma and select foreign names
- With Volatility on the Rise, Expect increased covered call writing
 - Mitigate Risk
 - Enhance Return
 - Generate Additional Income
- View pullbacks in the markets as buying opportunities>>Take Global View

Stocks: Running in Place?

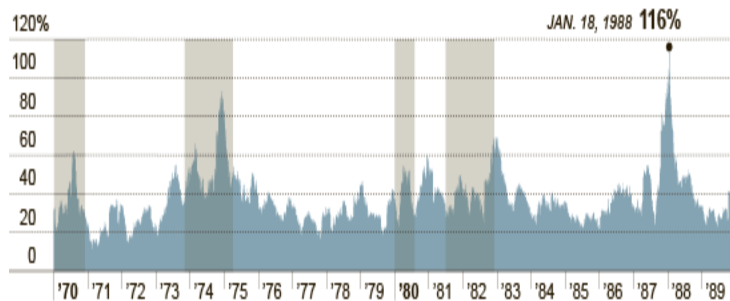


EXCESS STOCK MARKET VOLATILITY

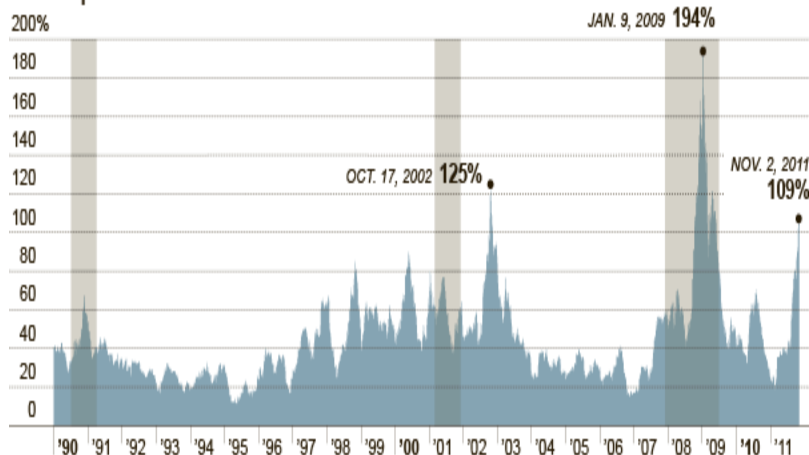
1950s and 60s



1970s and 80s



1990s to present



- Excess volatility has leaked into the markets to levels seen only three times in the last 60 years,
- Over the last three months there has been day after day of wild swings in prices, but the S&P 500 Index has moved almost nowhere.
- More specifically:
 - The S&P 500 closed at 1,260.34 on August 3rd and closed at 1,237.90 on November 2nd, a decline of less than 2%
 - During this period, however, the total move of the index was 1,392 points
 - It rose 684 points on good days and fell more than 707 points on bad days

The Rules of the Game



- Never bet against the end of the world...
 - ...even if you're right, you won't be around to collect
- Never bet against someone that can change the rules in the middle of the game
- Never bet against anyone that owns a printing press



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