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"The Best Days of My Life"

DHJ&A
DAVIS HAMILTON JACKSON & ASSOCIATES

I've been waiting for the inspiration to write my first letter of 2010. It finally came to me while driving home from work recently. When I turned on my radio, Bryan Adams' "Summer of 69" was the first song that came on. As Bryan sang "that summer seemed to last forever," I couldn't help but reflect on the summer of 2009.

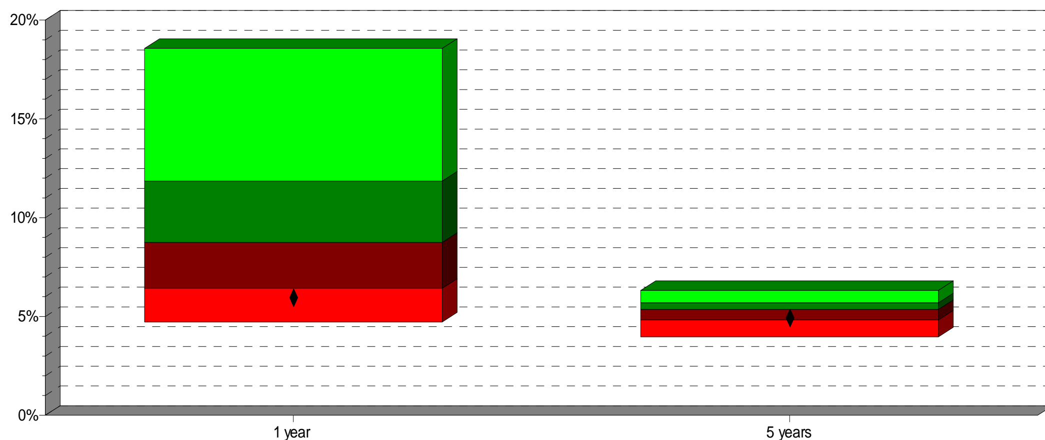
As background, we all remember the tortuous times of 2008. We remember the depression-like scenarios that crept into asset valuations. This led to extraordinary opportunities in early 2009 for those with the courage to invest against the "pack." It was truly Bond Nirvana! By the summer of 2009, the market took off.

It started in early April as the Financial Accounting Standards Board (FASB) relaxed the rules on mark-to-market accounting for major financial institutions. Before the rule change, banks were taking heavy losses on mortgage and asset-backed securities. Later in the month, Citigroup posted its first profit in 18 months. The company was able to produce positive earnings on the strength of reduced expenses, improved capital positioning and healthy trading gains. Then, Leading Economic Indicators rose in April for the first time in seven months. This positive news reassured investors that the tide had turned.

Consequently, the last three quarters of 2009 saw one of the strongest rallies on record. The S & P 500 returned 42.11% over this time period. In fixed income, the investment grade corporate bond index returned 21.02% with over 2,300 basis points of positive excess return.

Normally, at the end of each calendar year, managers wait with great anticipation for universe comparisons. For us, it is our industry's crowning of a "national champion." But for bond managers, it has been particularly exciting to await the results of 2009 as it was arguably the grandest year for bond managers ever!

The chart below is created with Zephyr StyleADVISOR, one widely used resource for manager universe rankings. The manager data is from Plan Sponsor Network's manager database which we recently received. The chart ranks 200 high grade fixed income managers who manage against the Barclay's Capital Aggregate Bond Index. Not only did most bond managers beat the Index last year, they beat it handily.



	1 year 201 mng	5 years 196 mng
5th Percentile	18.57%	6.32%
25th Percentile	11.86%	5.70%
Median	8.75%	5.36%
75th Percentile	6.43%	4.83%
95th Percentile	4.72%	3.97%
Barclays Capital US Aggregate Bond Index	5.93%	4.97%

Source: Zephyr StyleADVISOR

Looking at the chart, the Aggregate Index returned 5.93% in 2009 placing it in the bottom quartile of this universe. This means that over 75% of the managers in this universe beat the Index. Hats off to active management! Even more exciting is the dispersion in manager returns in 2009 as the difference between the top quartile and bottom quartile managers was almost 550 basis points—gigantic by normal standards.

Again, from the chart, over the last five years the Aggregate Index returned 4.97% annualized. This performance puts the Index at the bottom end of the third quartile for this time period—another strong showing for active managers.

With the historic fixed income performance of 2009 firmly behind us, what's the next big trade? Over the first part of 2010, we believe spreads, particularly corporate bond spreads, will continue to tighten. Nevertheless, we expect to reduce credit exposure in the latter part of the year, eventually moving to a marginal underweight. But, the next big trade will be preparing for rising short-term interest rates and a flattening yield curve. (My next investment letter will provide more detail on this subject.) Because of our outlook, we are already moving our portfolios accordingly to a "barbelled" position.

We expect bonds to do fine in 2010, but a repeat performance of 2009 is next to impossible. Bond managers can only dream about that "summer of 2009" while listening to the music of Bryan Adams.

"Oh when I look back now

That summer seemed to last forever

And if I had a choice

Yeah, I'd always want to be there

Those were the best days of my life."

Gilbert Andrew Garcia, CFA
Managing Partner
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