



2011 OUTLOOK

As our readers know, we are believers in **a.** the randomness of markets in the short term; **b.** the fragility of economies and financial systems; **c.** the unintended consequences of government policy; and **d.** for individual investors, we are believers in allocating risk appropriately for the long term. Conversely, we are critics of **a.** how the investment industry markets itself; **b.** the finance industry's level of influence in government; **c.** the government's attempts to manipulate the price of credit and influence the movement of capital; and **d.** market timing, trend-following and relying on technical charts as a way to predict the future.

In formulating our investment approach, we aim to identify multi-year, viable trends that will likely reshape global economic flows and benefit select sectors. We also focus on numerous risks that can adversely impact investments. As we approach each new year, we receive many questions about our outlook. While it's difficult to project changes in asset prices over a single year, here are several 2011 predictions that we believe provide a sustainable backdrop against which to invest:

1. Credit growth in the private sector will remain anemic as OECD financial institutions struggle with balance sheet quality. After people's negative experience with risky assets in 2008 and given an aging demography in the U.S. and Europe, the demand for and supply of credit will remain low.
2. Despite continued cyclical strengthening of the U.S. economy, unemployment will remain high: the economy is heavily skewed toward industries with excess capacity (namely residential real estate and financial services), many skilled jobs have been outsourced, technology continues to improve productivity and businesses fear increased future regulation and higher future tax rates, making them reluctant to hire.
3. The agreement on extending the existing tax rates will strengthen domestic economic activity, minimize the probability of a double dip and help the Obama presidency and the Democrats in 2011 and 2012.
4. Pricing power will be a bigger deal going forward. Up until now, many asset prices were correlated with each other as the Fed re-liquified the financial system with free money to large banks. Going forward, however, companies that can pass on higher labor and input costs will outperform those with excess capacity and where rising costs will squeeze margins.
5. Stocks will continue to outpace bonds and cash as risk appetite increases amidst both a continuing global recovery led by strong growth in the emerging markets and zero rates on deposits and money market instruments. Returns in both stocks and bonds over the next few years, however, will likely be below those of the last two years as asset prices have been successfully reflat off the panicky March 2009 lows.

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6. An emphasis on total return—as opposed to yield/income—will reward those who embrace the concept. Focusing purely on income will bias portfolios toward more interest-rate sensitive investments at a time of record-low bond yields. These investments will be vulnerable as rates rise.
7. Rising costs of living will persist globally. The cost of everything (with the exception of residential and commercial real estate in the U.S. and Europe) is likely to rise for the foreseeable future.
8. Unwinding excessive leverage and country tensions in Europe will continue to weigh on the euro. Periphery countries’ bureaucracies and welfare programs have long grown at a rate exceeding their GDPs and they are now at a tipping point. Continued bailouts will be needed to keep order in the eurozone, presenting near-to-intermediate term challenges to the euro.
9. Claims on high-quality natural resource producers will continue to be valuable. While many predict a near-term China retrenchment, emerging markets’ demand for raw materials will remain intact. As long as these countries continue to urbanize, the upside for investors in unhedged resources in politically secure areas will remain in place.

As with all predictions, not everything above will prove true. Several themes will likely take years to play out, and there will also be unanticipated developments. A few things to keep an eye on are oil prices and municipal finances in the U.S. These are two wild cards that are extremely difficult to handicap, but have a huge impact on the economy and investor psychology, and can affect financial markets. We construct portfolios given both what we know and *what we don’t know*, and we adapt our strategy as economies and markets evolve. ■

INVESTMENT COMMITTEE PERSPECTIVE

A CRITICAL ISSUE

One of the *most important* but *least discussed* considerations in engaging an investment advisor is the firm’s management of its *business risk*. Advisors who improperly manage or overly focus on business risk expose their clients to poor portfolio results and a lousy long-term outcome. The problem with this is that these advisors may settle for mediocrity or do exactly the wrong thing at the wrong time to avoid looking bad.

Business risk refers to the advisor’s business itself and is primarily viewed as the risk of losing clients. It is distinct from *investment risk*, which relates to the investment portfolio the advisor creates. However, while business risk and investment risk are different, they are also inextricably linked and *how* that link is handled can affect clients’ investment outcomes in a dramatic way.

Far too many professional investment advisors fixate on *business risk* as their number one concern and, to the detriment of their clients, manage this risk *through the investment portfolio itself*. They recognize that portfolio construction steers client perceptions (rational or irrational) and they seek to guide these perceptions. As such, managing business risk can influence advisors’ decision-making, often to the disadvantage of the very clients they seek to retain. Over-managing business risk can lead an advisor to hug benchmarks, use shortcuts and backward-looking statistics, over-diversify, make investments that have a *story* instead of substance, avoid

controversial or contrarian investments, take on excessive risk such as making large allocations to **popular** investments and/or avoid aggressive investing in panicky, liquidating markets despite the fact that this is the best time to commit capital. In essence, it can lead them to make poor decisions, and it's all for fear of losing clients.

Because liquidity moves in mysterious ways, most managers will have periods where they perform well and other periods where their performance lags. As such, it is ill-advised to place much emphasis on advisors' recent performance as a proxy for their skill, ability or advocacy—there is very little meaning in performance statistics for time periods shorter than a decade.

What **is** meaningful is an advisor's ability to help clients come up with a strategy and appropriate asset or risk allocation. In addition, the firm needs the ability to construct a strategic portfolio composed of high-quality investments, to build in hedges for unforeseen scenarios and to have experience and consistency in applying an investment process. **These are bare minimums.** For prospective clients to assess these abilities is important, but **equally** important is an understanding of the firm's philosophy toward its business risk!

In other words, it matters a lot whether an investment advisor is singularly focused on asset gathering, client retention and the perceptions of its clients. How the firm faces adverse or euphoric market conditions is also of critical importance. It can be extremely costly to a client if his or her advisor capitulates in adverse markets or jumps on the bandwagon in euphoric markets in an effort to avoid losing clients. Many investors experienced this in the late 1990s and in 2008-2009, and it often ended badly.

Admittedly, it is a delicate balancing act for advisors. The clients are the life blood of their business and no one wants to lose them. However, it is absolutely critical that, in order to do a good job on the investment side, advisors are willing to be bold, face controversy and stay focused on doing the right thing for all clients **at all times.** For Obermeyer Asset Management it sounds strange to say, but we need to risk looking bad for the benefit of our clients. If we're not comfortable being questioned, we are in the wrong business.

**“Our clients are
our business partners
and we are
their advocates.”**

As a fiduciary—a standard to which brokers and insurance agents are **not** held—we have a duty to manage our business risk in ways that do not adversely affect our clients. We do this through four primary practices:

1. **Spending time with clients up front** and only partnering with those whose temperaments and expectations are a good fit with our philosophy and process. Our clients understand that adverse markets happen and they want us to do the right thing, even if it appears contrary in the short-term.
2. **Making few, high-quality decisions.** More frequent decisions mean a lower probability of success with each trade in aggregate; we prefer well-thought-through decisions and we let time work in our favor.
3. **Remaining independent and focused.** We ignore benchmarks, are comfortable owning controversial investments, avoid exposure to investments that we find too opaque to analyze or that carry uncompensated risk, and remain objective, disciplined and emotionally detached in all market environments.
4. **Being totally transparent** in our views and communicative with our clients.

Our clients are our business partners and we are their advocates. For any business to be successful it needs good partners who have shared interests. Investment markets will always be challenging, but if thoughtfully managed with a focus on doing the right thing for **all clients all the time,** we think we can deliver superior outcomes. Always doing the right thing for clients is **not** the same as always pleasing clients. Understanding and accepting the difference is critical. ■

A little year-end humor...



“That may well be, sir, but my buy-low, sell-high app says ‘sell.’”

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WINTER READING

WHILE WE AT OBERMEYER ASSET MANAGEMENT

focus primarily on reading industry publications and independent research reports, we all enjoy books about the market, economics and current affairs. One recent worthy read is *On the Brink* by Henry Paulson, Jr., Secretary of the Treasury under the George W. Bush administration and former CEO of Goldman Sachs.

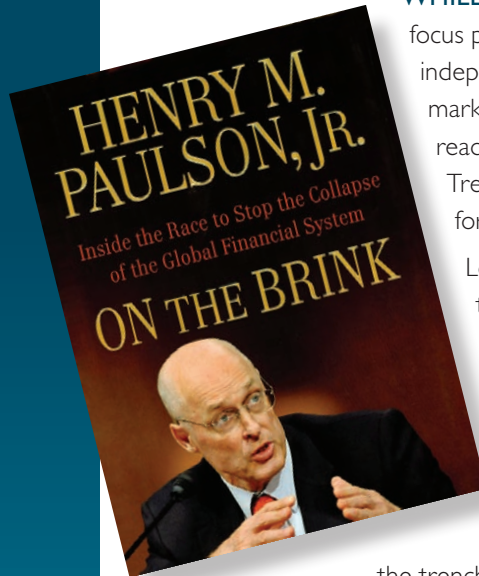
Lonny had the opportunity to hear Paulson's account of the financial crisis firsthand at an investment conference this past October. A very engaging speaker, Paulson gave an insider's view of what really transpired during the tumultuous summer and fall of 2008. His public role during this time—and his intimate knowledge of Wall Street—enticed us to read his book.

On the Brink provides a day-by-day narrative from the trenches during the global financial crisis. It reveals the

inner workings of the Treasury and its partnership with the Fed and other government leaders as they navigated bank failures, an unprecedented liquidity squeeze and a dated regulatory framework. The book is a little heavy on industry jargon and product specifics, but offers enough explanation that most readers should be able to follow its chronicle of events.

On the Brink is a fast-paced, almost gossipy recount of what it was like to be at the epicenter of 2008's financial crisis. We recognize Paulson wrote this book with an eye to his place in history, so it is not without an agenda. His account, however, reminds us of the consequences of excess leverage and the senselessness of companies being run for the profit of a few at the expense of many.

If you are interested in reading Paulson's book, please let us know and we are more than happy to give you a copy. ■



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Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels.

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