

OUTLOOK 2009

What's Next for the Markets & the Economy

TRANSCRIPT

OUTLOOK 2009: Top Investment Themes for 2009

THE PANELISTS

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ADAM QUINTON: In the RIC Report [Research Investment Committee Report], published last December, looking at 2009 year ahead, there were a number of short-term and longer-term themes that were identified, and I think it's worthwhile just elaborating a little bit more on those. So, I'll actually start with you Michael. Japan--that was a short-term tactical theme. Just explain a little bit about what the idea is there.

THEME FOR 2009: JAPAN *Relatively Small Financial Sector*

MICHAEL HARTNETT: Well, Number One: Japan is a relatively low beta market, and one of the reasons being, it has a fairly small financial sector within the broader market. So it's less vulnerable to the vagaries of, if you like, the credit cycle that we're going through.

THEME FOR 2009: JAPAN *Potential for Currency Gains*

Number Two: You've got the potential for currency gains there, and we think the yen is, is roughly 10%, 20% undervalued.

THEME FOR 2009: JAPAN *Dominant Global Companies*

And Number Three: There are a number of very dominant global companies in Japan and industries such as autos.

RISKS FOR JAPAN: *Dramatic Recovery in Global Economy*

I think the, the risk to Japan would simply be that you get a, a dramatic recovery in the global

economy in 2009. In the absence of that, we think Japan's a reasonable place to be internationally.

THEME FOR 2009: DEFENSIVE STOCKS
Typically Tend to Be Necessities

AQ: And Rich, in terms of the more domestic themes, again, just running through them quickly--defensive stocks ... just tell us why defensive stocks?

RICHARD BERNSTEIN: All right, defensive stocks, because they tend to be necessities. They're not really susceptible to the economic cycle and yet they're still undervalued, despite how the economy has performed. Things like consumer staples, healthcare, to a lesser extent, things like utilities and telecom stocks.

RISKS FOR DEFENSIVE STOCKS:
Dramatic Pick-Up in Economy

The risk, much like many of our themes, is that the economy picks up dramatically. Obviously, defensive stocks don't have the cyclical to keep up with the more economic-sensitive sectors.

THEME FOR 2009: HIGH-QUALITY BONDS
Quality Is "Paramount" in Portfolios

AQ: And we're sticking with high-quality bonds and Treasuries. What are the opportunities and risks there?

RB: You know, high-quality bonds and Treasuries simply because we think the quality is paramount in the fixed-income portfolio--and in the equity portfolio right now as well.

RISKS FOR HIGH-QUALITY BONDS:
Inflation Makes a Comeback

RB: And the risks are really, well, what if inflation did come back? We think that's unlikely, but if inflation came back or, again, if nominal growth in the economy began to accelerate, obviously fixed income doesn't do as well in those environments.

THEME FOR 2009: MID-CAP GROWTH
Favoring Growth Over Value

AQ: And then the last one on the list for short-term tactical ideas: mid-cap growth. Just tell us a bit about that one.

RB: Mid-cap growth ... we favor growth over value. Growth tends to work better during slowing economies and economies in downturns.

THEME FOR 2009: MID-CAP GROWTH
Selling at Single-Digit P/E Ratios

RB: But mid-cap growth right now is selling at a single-digit price/earnings ratio for the first time in history. So it may be slightly advantageous to buy mid-cap growth over large-cap growth. But we like both, to be perfectly honest.

AQ: OK, so, for the short term, we've got Japanese equities, we've got defensive stocks, high-quality bonds and Treasuries, mid-cap growth.

THEME FOR 2009: U.S. INFRASTRUCTURE
Long-Term Strategic Theme

AQ: Let's just stretch the time horizon out a bit, long-term strategic--U.S. infrastructure obviously. End of last year, the President-elect started to talk about investment in infrastructure. So what should people be doing there, Rich?

RB: Right. That's continuing. I think, in the infrastructure theme, one has to be very careful about the difference between companies that will benefit from water and highway infrastructure and those that will be hurt from the cutbacks in, in energy capital spending. We have to be very careful about that.

RISKS FOR U.S. INFRASTRUCTURE:
Change in Political Approach

RB: What's the risk? The risk is, for some reason, politics is politics. Maybe some of these plans don't turn out to be as big as people thought.

THEME FOR 2009: EM CONSUMER
Long-Term Strategic Theme

AQ: And the second, longer-term strategic theme was the emerging market consumer. I guess people might struggle to understand why that would be a, a good idea in this sort of global recession. So Michael, what's the idea there?

THEME FOR 2009: EM CONSUMER
Benefits from "Growth and Scarcity"

MH: I think, two words—growth and scarcity. I mean, there's still a lot of growth in the emerging market consumer, mainly because of demographics. Scarcity works as well, because there are very, very few ways, particularly in the emerging markets, to play them. So, so we think that those emerging-market-consumer plays in China or Brazil, wherever they are, will do well.

The other thing I'd add, of course, is that it also plays very nicely with the Merrill theme of U.S. multinationals. I mean, you've got a lot of companies outside of emerging markets that are going to do very well through that growth in the emerging market consumer.

AQ: What are the risks there?

**RISKS FOR EM CONSUMERS:
*Inflation Comes “Roaring Back”***

MH: Well, probably the biggest risk is, is that we’re wrong about inflation. Inflation comes roaring back for one reason or another, and that compromises the purchasing power of, of the emerging market consumer.

**THEME FOR 2009: “BEST OF BREED”
*Emerging Market Multinationals***

AQ: And you mentioned multinationals. The third longer-term theme was best of breed. So does that capture that idea of strong multinationals? What are we thinking about there?

MH: Yeah, I think that, again, you’re looking for something that, that is almost a twofer.

**THEME FOR 2009: “BEST OF BREED”
*Works Well in a Bear Market***

MH: I mean it will work in a bear market, because you get the best companies, the best brand, the best product, the best management, and the best balance sheet. That’s really what you’re trying to, to have in your portfolio. But I think even if the bull market comes back, I mean, these companies will still do very well. So I think that best of breed is a very sensible strategy in 2009 and 2010.

AQ: How could that go wrong? What are the risks in that idea?

**RISKS FOR “BEST OF BREED”:
*Move Back to the “Old Leadership”***

MH: Well, I think the biggest risk is, is again, the market sort of moves quickly back to what Rich would term the old leadership and you start to get sort of small cap, high beta, commodity-related stocks really do extremely well again, because we misjudge sort of what inflation does over the next couple of years. That would be the biggest risk to the best-of- breed theme.

**THEME FOR 2009: DEFENSE STOCKS
*Perform Better Under Democratic Administrations***

AQ: Now Rich, we’ve talked about defensive stocks as a tactical idea. What about defense stocks as a strategic long-term idea? What are we thinking about that?

RB: Right. Well, defense stocks, unfortunately, not the most socially responsible theme we can come up with, but ... defense stocks tend to perform better under Democratic administrations than in Republican, surprising to many.

THEME FOR 2009: DEFENSE STOCKS ***Defense Spending Currently Low As % of GDP***

RB: Number two: defense spending as a percent of GDP is remarkably low, relative to history. Dave has pointed that out many times.

RISKS FOR DEFENSE STOCKS: ***Administration Cuts Back on Defense Spending***

RB: I think the risk here is that for some reason we do find a Democratic administration cuts back on defense spending. That would clearly be bad for these stocks.

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