

## RCM US Strategic Outlook with Co-CIOs Peter Anderson and Scott Migliori



Christian Pachtner,  
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**Christian Pachtner:** Good morning and good afternoon to our participants from Europe as well and welcome to our RCM's U.S. Update call. My name is Christian Pachtner; I'm head of Client Relations here. On behalf of RCM, thank you very much for joining us today.

I'm here with our Co-CIOs Pete Anderson and Scott Migliori. In the next 30 minutes we will talk about what happened since our last call at the end of March. We will then share our latest outlook on the U.S. economy and the U.S. markets. And finally we'll talk about performance in your portfolios and comment on the current positioning. At the end of the call we'll make sure to address the questions that have been submitted by you in advance.

Let me now hand over to Pete Anderson so he can walk us through the current market environment. Pete...



Peter Anderson  
Co-CIO RCM US

**Peter Anderson:** Thank you Christian and good morning. Let's do a quick review of April and May, but first of all as we all know April was a month of explosive upside performance. And in recognition of the green shoots – an overused word but nevertheless that's what we're seeing, lots of green shoots – energy, materials, industrials, financials, and consumer discretionary all outperformed in the month of April. The Tech sector basically was a neutral to the market and the healthcare, consumer staple, utility and telecom areas underperformed.

And the same pattern emerged in the month of May. May was more of a grinding month rather than an explosive month, but nevertheless the month of May turned out to also be a fairly positive market environment. Treasury yields misbehaved, particularly during the month of May and moved significantly higher. Commodities showed significant volatility to the upside, particularly in the energy complex and the dollar in general declined.

So where are we going from here? Well in general RCM is optimistic, both about the economy and the market.

Regarding the economy, first of all monetary policy as you all know has been extremely stimulative and the result of that stimulative monetary policy is that interest rates, other than Treasuries, have moved materially lower and remain lower. Yield spreads have come in significantly and I will later on address the question from oil and treasury markets.

Number two, fiscal policy has been unbelievably stimulative. It has come in the form of tax cuts, social security payments, infrastructure spending, bailouts and numerous other fiscal initiatives.

We happen to believe that we will see inventory rebuilding in coming months. We've seen a very sharp reduction in inventories which has contributed to the steepness of the economic decline, and we think that's going to reverse itself. You will see inventory rebuilding later this year.

Consumer confidence has stabilized and as consumer confidence has stabilized we're beginning to see very early indications that retail sales are also stabilizing. We expect later this year that they will begin to move up. And part of that's going to be spared by the fact that we have pent-up demand we believe for both housing and autos.

At the bottom we were selling about 8-1/2 million autos here in the United States. Scrapage is more on the order of about 12-1/2 million units. Peak sales were close to 18 million units. So off of this extraordinarily depressed level I think it's reasonable that you would expect a rebound. The same is going to be true in housing.

Stocks in our opinion are reasonably valued. We're using \$75 for next year's S&P 500 earnings. If that number proves accurate, the market is selling for approximately 12.5 times that number which by historic standards is very, very reasonable.

I think one of the big surprises we're going to see next year – in fact even later here in '09 – is that earnings are going to be stronger than anticipated. We have rebuilt into the system an enormous amount of operating leverage

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and that's going to become really clear – really apparent as the economy begins to turn and we start running somewhat stronger volumes through the system.

Investors are cautious and that's the good news. There's plenty of liquidity out there in the hands of retail investors. It's interesting to me that for the first time in 16 years, money market funds – the size of assets in money market funds, exceed the total assets in all stock funds in the United States. We have not seen that for 16 years.

Liquidity in the hands of retail investors now equals 70% of real GDP – just a few years ago that number was more on the order of 50%. So, lots of liquidity in the hands of retail investors.

Institutional investors are under-invested relative to their normal benchmarks in equities. Hedge funds have significant short-positions, and in general most folks or at least many folks are looking for a correction in the market as an opportunity to buy. I think those corrections will be short and those corrections will be shallow – I'm not saying we won't have corrections; of course we're going to have corrections, but they're going to be relatively short and relatively shallow as investors seek opportunities to move back into the market.

You've got to realize the threat that the current market environment represents for most asset managers. If you underperformed last year in a down market and you failed to outperform this year in an up market, it could be curtains for you and your business and that puts a lot of pressure on folks to come back into a rising market.

Let's talk about near-term risks because I don't want to be Pollyannaish about this. The near-term risks are, well instead of getting the u-like recovery which we are anticipating with growth commencing in the fourth quarter of '09 and then slowly accelerating through '10 and '11 – instead of that we get an "L". By an "L" I mean we hit bottom, but we fail to generate a real recovery. That obviously would be an extremely negative scenario – negative for profits, negative for employment, negative in a lot of different ways, and would reintroduce stress into the financial system.

Equally as dangerous is what some people refer to as the square root; a sudden surge – a very sudden surge in growth but then followed by the economy once again going flat. Again, temporarily that might be good for equity markets but in the longer run a problem.

Those are near-term risks. Let me talk more importantly about what I perceive to be longer-term risks and then I'm going to stop and turn it over to Scott.

Longer-term risks revolve around the fact that we are running or may run close to the \$2 trillion budget deficit in the current fiscal year; close to a \$1.5 trillion budget deficit in the following fiscal year, and budget deficits of \$600 billion to \$900 billion to in some cases over \$1 trillion as we look out at the two, three and four years beyond the next two. So we're looking at an enormous accumulation of debt here in the United States. That obviously carries with it significant risks, longer term of inflation, of dollar depreciation, higher interest rates, and higher taxes. We have turmoil right now in the Treasury market. We have turmoil for that matter in the currency and commodity markets. I am hopeful that that is a temporary phenomenon.

We have seen rising interest rates in the Treasury market in past recoveries – the early stages of past recoveries and then the markets have settled back down again. I'm hopeful we will see that again. That the lightening that we are witnessing in the Treasury market is a sign – yes, it is the sign of an oncoming storm but the storm is two or three years away. If we're wrong about that and the storm is now and not two to three years away, that will represent an enormous issue for the market because right here, right now, still mired in a recession, we don't have the flexibility to deal with some sort of major crisis in the Treasury market.

So that's your risks. Some of these are near-term. Corrections yes – we think they will be shallow; we think they will be short. In general we're optimistic. I refer to the period we're going in to – maybe somewhat hopefully, as the golden window.

And with that I'll turn it back to Christian.

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**Christian Pachtner:** Thank you Pete. And I'll hand it over to Scott to talk a little bit more about performance, current portfolio positioning and share his views as well.

**Scott Migliori:** Thank you Christian. I wanted to talk about first the positioning and some of the changes of what I would call structural changes we've made to many of the portfolios over the last several months. Talk about the impact of that in terms of performance and what we're doing currently.

As you may recall from prior calls and prior conversations, really going back as far as last November, we were using market weakness to change the structure of the portfolios away from a more defensive stance towards more of a pro-cyclical stance. And our defensive stance – and what I mean by defensive is a heavy exposure to healthcare for example and other non-economically sensitive areas – that type of portfolio certainly served us well in 2008 given the nature of the market and the nature of the economy. But we did begin shifting into what I would call more pro-cyclical areas beginning back in November and certainly currently through March and April into areas such as technology, energy, consumer discretionary. And in some cases those areas were not big exposures in the portfolios, so it was a rebuilding exercise.

And what we've – the reason we were doing that in part was some of these economic recovery themes we've been talking about – leading indicators including the shape of the yield curve, the amount of quantitative easing, inventory to sales ratios, peaking in initial unemployment claims – all of which have historically been pretty strong leading indicators of economic recovery. When you combine that with very attractive, relative valuations in a number of these economically sensitive areas that was really the driver. We were able to still, as is our nature, focus on those companies that are high quality companies regardless of industry, but on the margin, also those companies that did have a higher degree of economic sensitivity.

So that's what we've been doing for the last several months and that did serve us well. That did begin paying off certainly from the lows in March. From March 9 through the end of May we have the S&P up over 35% and certainly that's continued in the early days of June.

So it's been a tremendous recovery and a very rapid recovery in terms of equity market performance that has been led, as Peter referenced, by a number of the more cyclical areas – energy, financials, discretionary among them. And the portfolios now certainly have benefitted from that. Most portfolios – it's obviously hard to talk in too much specifics because we have a number of products, a number of portfolio managers, but in general most of our institutional portfolios are up anywhere between 10 and 15 percentage points year-to-date on an absolute basis which is certainly a nice recovery story from some of the numbers we had last year. And again on a relative performance standpoint, we're talking about outperformance anywhere between 200 basis points and 1000 basis points of relative outperformance year-to-date. So we're certainly encouraged by those types of numbers. That the performance has been able to be maintained even with the significant recovery we've seen.

In the month of May, the most recent month, the market – the S&P was up over 5-1/2%. And nearly all of our strategies were either in line or outperformed for the month. So, again we're very encouraged by the performance.

The fact that we've managed to participate – well first of all, we've managed to weather at very difficult storm in a very difficult period last year and in the early part of this year. And then to be able to come out of that maintaining our performance trend has been very encouraging, and also at the same time staying true to our high quality nature in terms of our investment style.

So from here I do think it gets a little bit more challenging. The correlation between all the stocks and the move in the market has been quite high. It's been very much a beta call – a pro-cyclical call from the lows in March, and we've seen a 35% gain in less than three months.

So while we are still optimistic, I think the rate of improvement in terms of the stock market is likely to slow. I don't think we're expecting – I know we're not expecting another 30% move up in the next three months. I do think it will be a slower march higher and I do think that as implications for how we're structured from a portfolio standpoint, much of the structural changes I discussed, moving to more of a pro-cyclical stance, I think are behind

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US.

From here I do think it becomes much more stock specific, which from our standpoint and my standpoint is not a bad thing. Given our bottom-up track record; given our strength in terms of Grassroots<sup>SM</sup> and our sector analyst, I think moving to more of a stock specific environment; it should serve and play to our strengths. Now in addition to that, we actually have in a number of cases, taken some modest profits in some of these cyclical areas that have had significant moves here. We're talking on the order of 50, 60, 70, and in some cases even 90% moves off of their lows, and especially let's say in the energy area. I know energy has been an area where a number of portfolio managers recently have taken modest trends. You've seen the oil price rise from the low 40s actually up to as close as \$70 just here in the last couple of months. So I think it's certainly prudent to look for opportunities to take profits where appropriate as well.

So going forward as I say, it's going to be, I think, a much more of a stock picking environment which should bode well for us, but we do still expect to see further gains in the equity markets from here.

And with that I'll turn it back over to Christian and I believe you have some questions.

**Christian Pachtner:** Great, thank you Scott. Let's turn to some of the questions that you have submitted before the call. Thanks to all of you who have posed those interesting questions.

Let me start with the first broader question here – number one, "Can you give thoughts about inflation; both near-term and more long-term?" I think probably a question for you Pete.

**Peter Anderson:** Well, first of all inflationary pressure I think in the near-term are going to be extremely modest. We've got plenty of everything. We have plenty of industrial capacity; we have certainly plenty of labor, and I think actually, despite the surge in commodities, we certainly have an adequate supply of commodities.

So although we're seeing a rise in commodity prices, reflecting both certain fears and an anticipation of an economic recovery, I don't think inflation is on the near-term horizon.

Longer-term obviously, I think concerns are growing. That's again a reflection of the enormous budget deficit which we are currently running and a very rapid growth in the money supply. And reflecting those things as we look out two, three, four years – and I'm really thinking more like three to four – as economies recover around the globe which is what we expect, as capacity utilization tightens, as excess labor is siphoned back into the economy, I think it's only logical to believe that inflation will pick up. So it is going to be an issue as we look further out in time. But in the near-term, we don't think it's a big problem.

**Christian Pachtner:** Thanks Pete. The second question comes also from a client in the U.S. – "What are the most salient risks that you see; and are there any that you could possibly envision that others aren't talking about besides natural disasters, terrorist acts; etc.?"

**Peter Anderson:** Well, I'll take that one and then I think I'll toss it over to Scott who'll have his own take on it.

And I really have already touched on what I think the biggest, longer-term issue for us is which is we've got to come to grips with this budget deficit question. We simply cannot lend these kinds of numbers. We don't have adequate internal savings to deal with \$2 trillion and \$1.5 trillion budget numbers. And we're also a country which has a negative balance of trade which is not helpful. So we've got to bring those numbers down and we've got to bring them down in a very significant way and that is going to be difficult without very large tax increases. If we have very large tax increases or significant reductions in programs such as Social Security and Medicare, that is likely to slow the growth rate of the economy looking out let's say three or four years from now.

So there are some very real risks. I envision many of those risks to be further out in time, but I am not belittling these risks. These are very serious risks.

**Scott Migliori:** I would just add on top of that, in terms of expectations, it's interesting because we started this year with a forecast of an economic recovery in Q4. And in January and the dark days of February, that was certainly a non-consensus call. Most forecasters, most economists did not have recovery until 2010 if not later

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than that.

Now you've seen a real shift in expectations, a shift in consensus towards our view and in fact in some cases, even more aggressive in our view. And I guess when you think about concerns that could impact the market and cause a pullback that Peter and I – or Peter has talked about; it certainly could be the case that the expectations are getting a little bit too high for a Q3 recovery.

We're still on board with the recovery in Q4, but as I say, we've see a significant shift in expectations where now anything short of a recovery in Q3 could cause some short-term dislocation in the market.

But ultimately, we would view that as a buying opportunity because we are positively biased towards 2010.

**Christian Pachtner:** Thanks Scott. The next question, again a more general question on the sustainability of this rally, the question received is, "What's RCM research and indicators are pointing to as to the sustainability of the rally we are experiencing? Should we expect another significant pullback or re-testing the lows or a sluggish recovery?"

**Peter Anderson:** I'll take that one and then I'm going to pass that question over to Scott in terms of what our analysts and PMs are seeing.

First of all, I don't think we're going to re-test the lows. As you remember back in March the low was on the S&P 500, 666. I don't think we're even going to faintly approach that low.

Are we going to have occasional pullbacks or pauses in this ongoing market move? Well absolutely we will. Is it going to be more grinding in terms of movement to the upside than it was in April? Absolutely. But are we going to see major corrections or a full re-test? I will be really; really surprised to see that occur.

So I'm going to pass it over to Scott and have him talk about what our analysts are seeing.

**Scott Migliori:** In terms of what we're seeing from a research standpoint, as a bottom-up manager, not surprisingly given the GDP numbers we're still seeing, things are weak out there in a number of areas. You are seeing some signs of stabilization, but in general it is very tepid and that shouldn't be surprising given that we're at the very early stages I think of a recovery. But what we are seeing in a number of areas, specifically and certainly in technology as well as in the retail area is a massive amount of inventory reduction, and you've also seen very significant cuts in SG&A.

As a result of that, I think it's surprising to a lot of people; earnings results in the most recent quarter are actually pretty good both in technology as well as in some of the consumer discretionary areas because of the massive cost cutting that's taking place.

So to Peter's earlier point, to the extent we do see a re-acceleration in volume and in revenue, we are set up to have significant operating leverage in a number of our companies which I think will surprise people on the upside from an earnings standpoint.

**Peter Anderson:** You have to bear in mind that while we have in the system reduced financial leverage, what we are also doing is introducing steadily more operating leverage as we reduce inventories and reduce employment. That's what has us excited about earnings prospects as we move into '10 and a more vigorous economy.

**Christian Pachtner:** Thank you. And I think we have time for one last question. "Does the global economic uncertainty negatively affect your ability to forecast revenues and sales volumes and the growth thereof? If so, how much confidence do you have in your projections of corporate earnings, what specific steps are you taking to adapt security selection in this very uncertain environment?"

**Scott Migliori:** Certainly whenever you have an inflection point, whether it's an inflection point down or an inflection point up, there is a wide dispersion of possibilities and estimates from Wall Street and from others. So it does, from a forecasting standpoint it does require that you do a lot of scenario analysis which is what our analysts do both in terms of upside possibilities and downside, and to come to a estimate that you think is a

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reasonable approximation of what could happen, but by – at the same time going – being fully cognizant of the upside risks and downside risks.

Now the good news is with valuation levels as low as they are, it's possible to take that type of risk from an earnings estimate standpoint without facing a lot of downside risks from a stock perspective.

So certainly in the areas that are more economically sensitive, forecasting right now is more challenging which is why we do the scenario analysis we do. But a lot of the stocks that we own are much more product cycle driven where you do have data points that you can track and you monitor and extrapolate that are not purely GDP driven.

And Apple is one case in point, and certainly a number of our healthcare holdings where really by using Grassroots<sup>SM</sup>; by using our fundamental research, we're able to continue to model out and forecast with a high degree of accuracy.

So I think it does depend on what industry you're talking about. Obviously the more economically sensitive ones we have to do more scenario analysis. The more product cycle sensitive areas, we continue to do the type of fundamental bottom-up research we've always done.

**Christian Pachtner:** Great, thank you Scott.

Well let me thank all the clients for submitting those great questions.

As we come to the close of this call let me thank Pete and Scott for their comments and sharing their views with us. We will provide, as usual a recording and a transcript of the call to all participants and will forward it to you as soon as it is available.

So that's it for the day. Thank you again for your interest in today's call and for your continued confidence in RCM. Goodbye.

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