



# Blue Shores Capital 2009 Review and 2010 Outlook

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*The tremendous rally in riskier assets over the past year is a reminder of the power of cheap money. In 2010, we believe things are going to get more complicated as the year progresses. In the following pages, we review the past year's financial markets and discuss what we did well and what we could have done better. We also discuss portfolio strategy and positioning for the coming year. In summary, we remain modestly pro-cyclical, but are far from having a dogmatic view of the market. As we exit the first phase of this cyclical bull market, which has been fueled by liquidity and low interest rates, we will be keeping a close eye on the sustainability of an economic and earnings rebound in developed markets.*

## The Great Reflation Strategy Engaged by Global Governments Worked in 2009

Global stock markets, and many other asset classes including corporate bonds, posted the strongest year of returns since 2003 as the Fed kept interest rates near 0% and global governments injected liquidity and stimuli at unprecedented levels. The goal was to stave off a global depression that appeared to be approaching after the collapse of Lehman Brothers along with most financial markets in 4Q 2008. In 2009, the MSCI World Index increased 30%, the S&P 500 26%, and bonds, as measured by the Barclays Aggregate Bond Index, rose 6%. The Blue Shores Global Equity Strategy returned over 26%, as did the U.S. Strategy, and the Taxable Fixed Income Strategy returned 5%, matching its Barclays Intermediate Government/Credit benchmark return<sup>1</sup>.

Are we as portfolio managers satisfied with our 2009 performance? Generally, yes. We modestly underperformed the benchmark due to a conservative approach as the rally progressed beyond recent norms. Nonetheless, our returns were quite competitive. After being fully invested in the initial market rally from the March lows until June, we hedged part of clients' equity exposure via synthetic short positions. At one point, we went down to approximately 75% net long exposure. We were cognizant of the old saying that "bulls and bears make money on Wall Street, but pigs get slaughtered." With the market having risen so much, we were concerned that a correction could occur of significant magnitude.

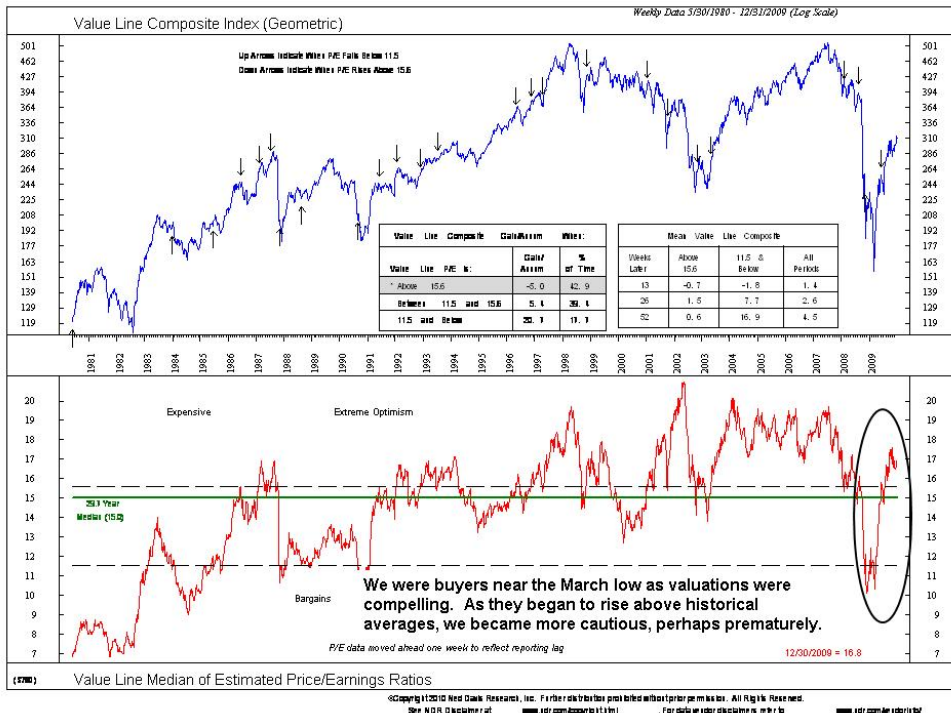
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*"Despite the strong equity markets, many investors, including ourselves, were white-knuckled throughout the year."*

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<sup>1</sup> Represents gross total returns for Blue Shores Global MCC Equity, U.S. MCC Equity, and Taxable Fixed Income Composites; individual client returns may vary. A fully GIPS® compliant performance presentation is available upon request for each of Blue Shores strategies.

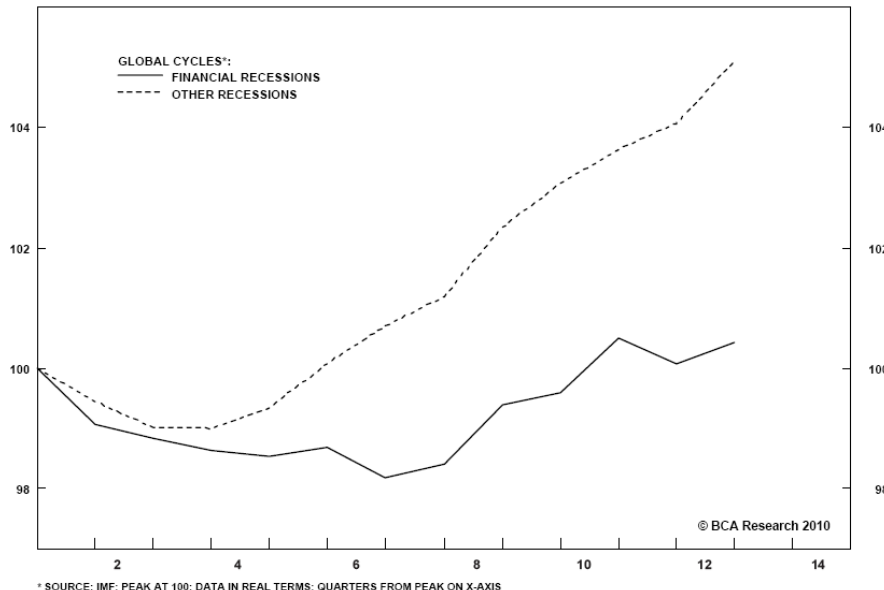
The stock market had a very shallow correction of about 7% and then turned upward again as we underestimated the strength of explosive liquidity conditions and the ability of American managements to dramatically cut costs in such a short time. We revised some of our outlook and added to long positions. That being said, we continue to believe we are still in a secular bear market and cyclic rallies should be



*"We continue to believe we are in a secular bear market and cyclic rallies should be viewed with caution."*

viewed with caution. The question on our minds through much of the year was whether we were simply seeing a bear market bounce or an actual cyclic economic recovery. It is now clear we are in some sort of a cyclic economic recovery. However, recessions that result from a financial crisis are different. Their recoveries are typically less robust than other recoveries. Not only that, but for the first time in decades,

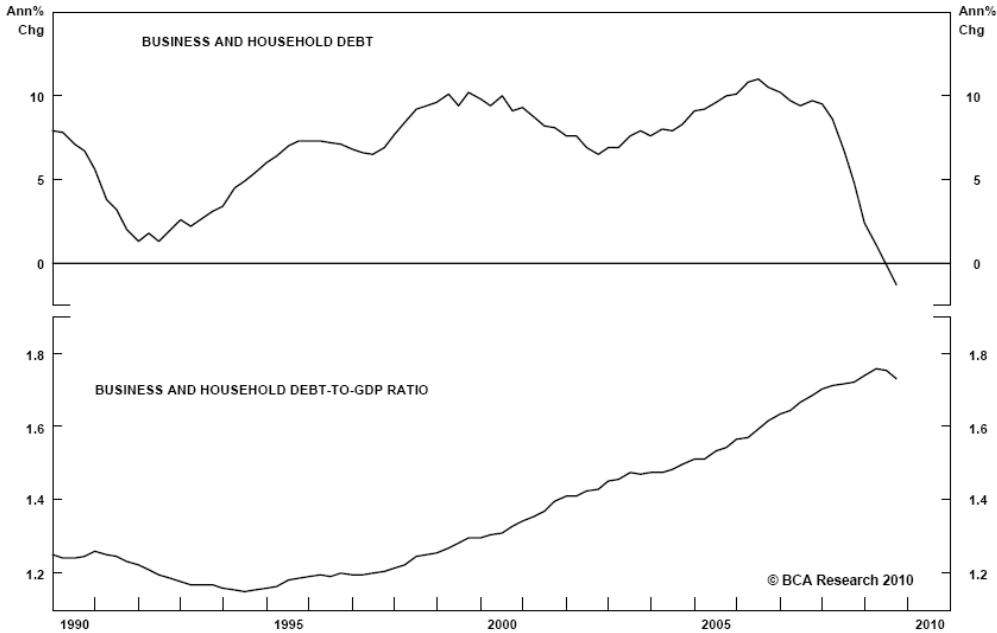
**Two Kinds Of Economic Cycles**



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U.S. consumers are deleveraging and we appear to be early in the process in the U.S. Consumer spending, historically the largest contributor to GDP (about 70%), will be lower than in the past. GDP growth will have to come from other sources. While the private sector is generally deleveraging, the public sector is leveraging up at an unsustainable rate.

**Credit Restraint Takes Hold In The U.S. Private Sector**




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*“Monetary traction in the United States and several other G7 countries is still dysfunctional.”*

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**The World Economy Remains Unstable**

Monetary traction in the United States and several other G7 countries is still dysfunctional. That is, while the Fed has dramatically increased the money supply, it has not found its way into the economy via credit creation.

**G6 Money Multiplier**



On the other hand, lending in China is near all time highs. Real estate values are red hot in parts of the Far East, while they have fallen substantially in the U.S., Japan, and most parts of Europe.

Over the past year, credit spreads have declined dramatically from recent historical highs as buyers of credit purchased with abandon. Yet, as we start 2010, credit spreads are still generally declining from recent historical highs, however, sovereign risk spreads appear to be increasing. The so called "PIIGS" in Europe (Portugal, Ireland, Italy, Greece and Spain) have fiscal crises on their hands. Additionally, many believe it is only a matter of time until the financial markets riot in the form of much higher interest rates or a dollar meltdown in response to the U.S.'s massive borrowing binge. In December alone, we witnessed the two-year treasury double, albeit from very low levels.

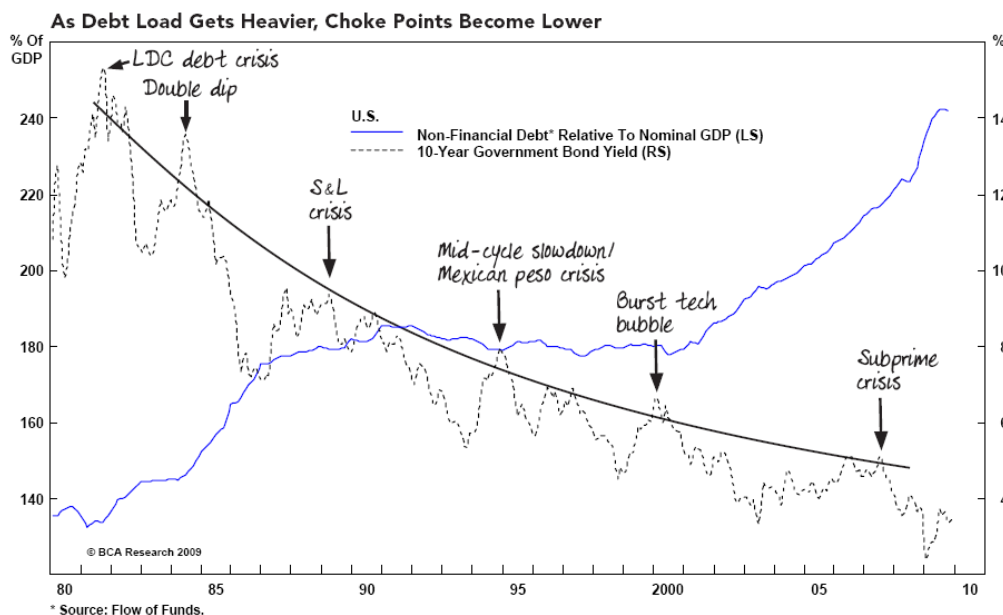
Within the U.S., we see other divergences. Large businesses have successfully bypassed banks and tapped the capital markets for credit. However, small businesses do not have that ability and they remain starved for credit. Make no mistake, the general trend for the global economy is recovery, but with substantial variation from country to country and within regions.

As mentioned, interest rates have recently begun to rise and, if they continue, we will find ourselves in a very tricky situation. Rising interest rates can be ignored for awhile, but eventually negatively affect the equity markets. If there is one concept we would like to get across to our clients

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at the beginning of this year, it is that the next "choking point" for the U.S. economy, in the form of higher interest rates, is unknown, but it is not likely very high (maybe 4.8%?). As debt levels have grown over the past 30 years, the interest rate level at which there has been a financial crisis has systematically moved lower.

The point of this entire discussion is that, while the global economy is recovering, things are nowhere near normal. Figuring out what type of organic growth we would have, without all the government subsidies (first

time home buyers, cash for clunkers, etc.), stimulus, and virtual 0% interest rates is a serious challenge. Such government efforts cannot last and it is difficult to say what the economy may look like 6-12 months from now due to a high level of uncertainty from fiscal (higher taxes), monetary (higher interest rates) and political policies. While we may be biased, we believe our global opportunistic approach to managing money, an approach that takes into account changing global macro economic conditions in addition to individual company fundamentals, seems as appropriate as ever. The ability to maneuver among countries, equity styles, and market exposure is particularly important as we enter 2010.

## Global Portfolio Sector Allocation Added to Performance, Market Exposure and Stock Selection Did Not

Throughout the year, we maintained a large overweight in the materials sector and finished the year with approximately a 9% overweight versus the global benchmark. This was our second highest value added decision in 2009 as the global materials sector returned 60%, aided by an approaching V-shaped manufacturing recovery (led by China) and a weak dollar. As many of our clients know, we believe material stocks are currently in a secular bull market, driven by Chinese commodity demand, and participating in the sector is a plank of our overall equity strategy.

Our underweight in the utilities sector also added value during the year. For most of the year, utilities (traditionally an early leader in a stock market recovery) were “the forgotten sector” and were left behind in a rising market that was dominated by riskier assets outperforming. The sector returned a measly 3% during the year.

The portfolio’s overweight in telecommunication stocks (mostly offshore) detracted the most from performance during the year, from a sector allocation perspective, because this sector, not unlike utilities, was largely ignored. The global telecom sector returned 8% for 2009. However, stock selection within the telecom sector proved to be our highest value added decision during the year. The average return of the four telecom stocks we own in clients’ global equity allocation was 49% in 2009. Two of the four telecom companies are in emerging markets, which had a strong year. We often point out to clients that, while telecom is not a growth sector in developed markets, it is in many emerging markets as infrastructure is developed.

The largest underweight in the global portfolio as we enter 2010 is the financial sector. Our underweight in the sector detracted from performance in 2009, as the sector increased 31% on a global basis. In particular, the financial sector rallied remarkably during the third quarter this year and we did not participate in a meaningful way. Many of the stocks that increased the most, such as AIG, Hartford Financial, and Fannie Mae, were at the heart of the financial market meltdown last year. In that sense, the poorest quality names were the biggest winners. We think the third quarter of 2009 was a “one hit wonder” in terms of seeing such dramatic financial sector outperformance. We view the probability of the financial sector

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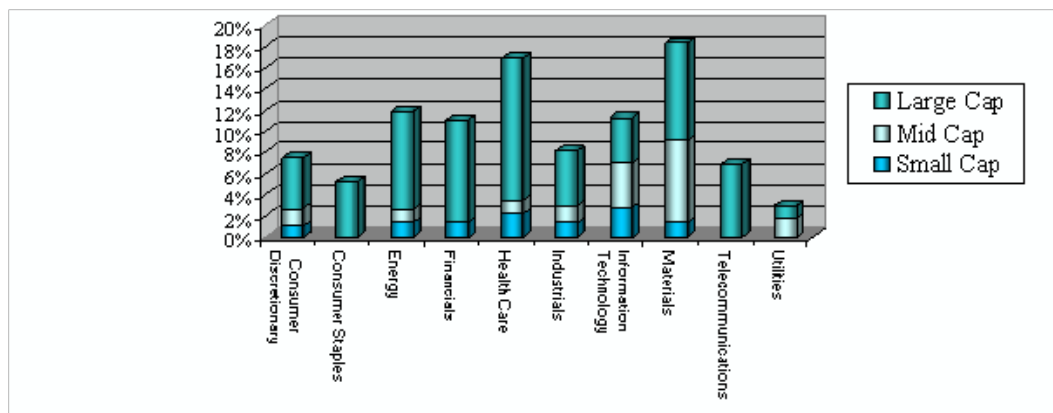
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*Sector Allocation as  
of 12/31/2009*

being a secular leader over the next decade as very small for a variety of reasons.

In addition to the telecom stock selection, stock selection benefited performance the second most in the consumer discretionary sector. Stock selection detracted the most from performance in the information technology sector, followed by the financial sector. It should be noted, however, that much of the underperformance in the technology sector was a result of a short semiconductor position we held as a hedge against our overweight in the sector for part of the year. The hedge proved detrimental. As for the financial stocks, we had no interest in purchasing the low quality financials that rallied so much in the third quarter and we still feel the same way. Fourth quarter financial sector performance was uninspiring.

## Three of the Top Five Best Performing Stocks Were International Companies

The top performing position for the year in the global portfolio was CarMax, trouncing the returns of next best performer by almost 90%. CarMax returned 208% during the year as many of the Armageddon-like headwinds began to dissipate. The company sells, finances, and services used and new cars through a chain of about 100 retail stores. It was formed in 1993 as a unit of Circuit City and was spun off into an independent company in late 2002.

As credit markets began to function again, CarMax's auto finance business could once again be viewed in a positive light rather than as a serious problem. (When credit markets did not function, they could not sell the loans they created.) What we did not anticipate, nor do we believe many investors did, is that the selling prices of used cars would increase this year and push up gross margins. The reason is because so many people are delaying purchasing a new car and thus the supply of trade-in vehicles has diminished. Additionally, cash for clunkers reduced the supply of used cars. These economic conditions enable CarMax to charge higher prices for used vehicles. We own the business in client portfolios because we think they have a winning business model in a very fragmented industry.

The second best performer was The Bank of Nova Scotia, based in Canada, with a return of 118% since we purchased it on March 4 of last year. Canada has the strongest banking system in the world; however, as the entire financial sector melted down in the U.S. during 4Q 2008, the shares of Canadian banks were brought down with them. This provided an opportunity to buy a high quality bank that also has significant Latin-American exposure with a solid 8% yield at cost.

The remaining three top performers in the global equity strategy were Rio Tinto, an Australian based mining company (+109%), Mobile Telesystems, which is the largest wireless carrier in Russia (+104%), and Goldman Sachs, a leading U.S. financial institution (+102%).

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*The securities referenced in this report are used to illustrate BSC's methodology. Securities selected by BSC for client portfolios under management may decline as well as increase in value. A list of all securities purchased and sold during the past 12 months by accounts using a similar investment strategy is available upon request.*

## The Five Weakest Stocks Were Mostly Financial Related

Lloyds Banking Group, a London based financial services firm, was the weakest performer for the global portfolio in 2009 with a quick and dramatic loss of 57% in less than a month. We sold it in late January. The company suddenly faced the risk of nationalization as it entered a downward spiral of asset prices and investor confidence.

The second worst performing position was a short position in semiconductors, implemented by holding an inverse industry ETF. As we mentioned earlier in the commentary, the position was viewed as a defensive hedge against our then large technology overweight position. Nonetheless, hedging proved to be detrimental to performance. The position lost 54% before we sold it on October 15. Since then, we believe we have enhanced our sell discipline concerning short-term hedges.

The remaining weakest performers were Aegon, a Netherlands-based life insurance company (-54%), Cardiac Sciences, a U.S. based microcap company that sells defibrillators (-47%), and AXA, a large French insurance company (-46%). Most of the positions have been sold from the portfolio early in the year to raise cash and await a better buying opportunity, which presented itself in March.



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## Returns Likely to be More Modest in 2010

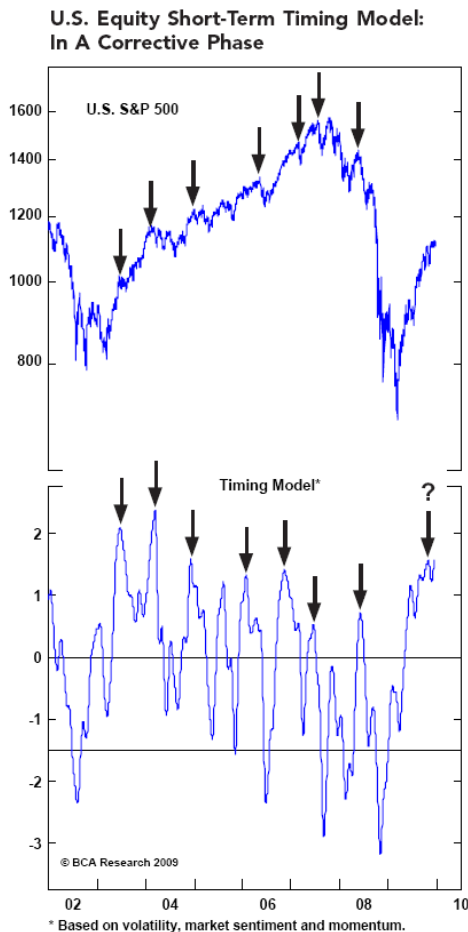
With a 60%+ rally off the markets’ lows in March, it appears the stock market has already priced in a robust economic recovery. This suggests that, while the economy will strengthen during much of 2010, the outlook for financial markets is more ambiguous. We enter the year with

an overbought market and high investor sentiment, which suggests near-term caution. Nonetheless, the broad macro economic conditions that were in place through much of 2009 that helped push asset prices higher are still in place. That is, interest rates are still low, and profitability and economic growth is still increasing. Comparisons of results against 4Q 2008 should be easy for many companies. While the conditions are in

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*Many of the conditions that have pushed asset prices higher are still in place.*

*Although, we enter 2010 with some short-term technical vulnerabilities*

place for a robust first quarter, things will get more complicated later in the year. As the economy recovers, investors will begin to focus on higher inflation and interest rates- two items that can derail a cyclical bull market. Another issue to keep an eye on is the U.S. dollar. A rising U.S. dollar could disengage the reflation trade that has been in place since March. On the other hand, a sharp drop in the dollar will push up import prices, which would put additional upward pressure on inflation. Tax increases and additional regulation appear inevitable during the year, which directly affects after-tax profits.

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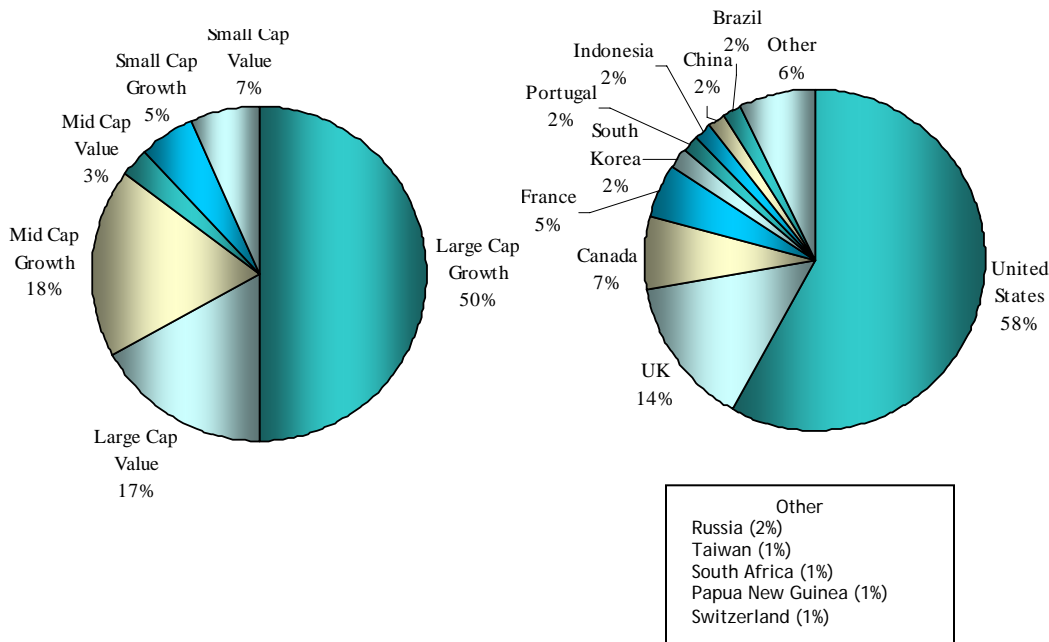
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## We Favor High Quality Names in 2010

Despite all the issues that remain in the U.S. economy, 2009 witnessed low-quality stocks lead the rally off the low. The lesson here is not to underestimate the power of cheap money. As the economy finds footing, the Fed will gradually begin to remove the liquidity facilities that were put in place during 2008 and 2009 and ultimately raise rates. Leading economic indicators have rebounded strongly, but are likely to increase





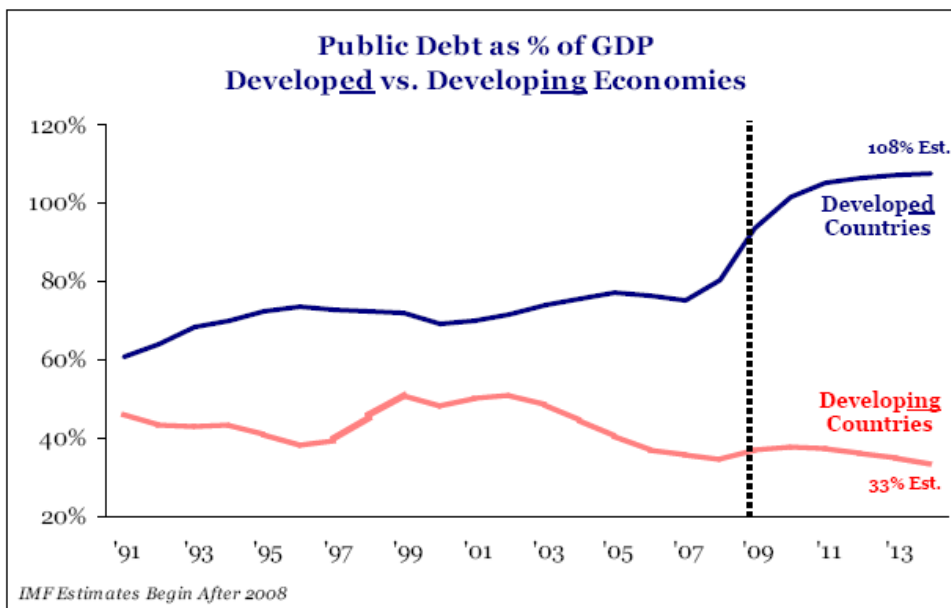
For this report, Blue Shores categorizes stock capitalizations as follows: less than \$2 bil. as small, between \$2 and \$10 bil. as mid, and greater than \$10 bil. as large. Stocks with a price to book ratio greater than or equal to 1.8 are categorized as growth; those below 1.8 are categorized as value. Sectors from Standards & Poors.

## Our Secular Themes Remain in Place

We continue to believe in the China-driven commodity demand theme from a secular perspective, and hence, our overweight in materials. We also have maintained precious metal exposure as the global money printing continues. Additionally, we purchased some companies we think may benefit from the new global political economic realities that are located in the nuclear and solar industries.

Structurally, emerging markets appear stronger than many of their G7 counterparts. In our opinion, emerging markets will provide superior

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returns over the coming decade; however the ride may be volatile at times. Investing in emerging markets is now a very consensus concept, so the trade will get crowded at times. Additionally, emerging markets are good candidates for the next “bubble” that is being fueled by the latest round of very low interest rates. (We do not believe they currently are a bubble, however). Basically, emerging economies are being “supercharged” by global interest rates that are much lower than what an equilibrium level would be with such fast growing economies. For example, an economy growing at 7% a year should probably have long-term interest rates closer to 7% than 2%.

The most recent strategy adjustment would be our recent boost to the healthcare weighting to overweight. It appears now that the healthcare bill likely to be passed by Congress will not have a whole lot of “teeth” in it, in terms of mandates that would turn healthcare companies’ business models or competitive landscapes upside-down. We think the shares of a number of healthcare companies have been pricing the worst case scenario, which does not appear to be evolving. It is one of the few areas where we still see solid value given the stock market rally off the March lows.

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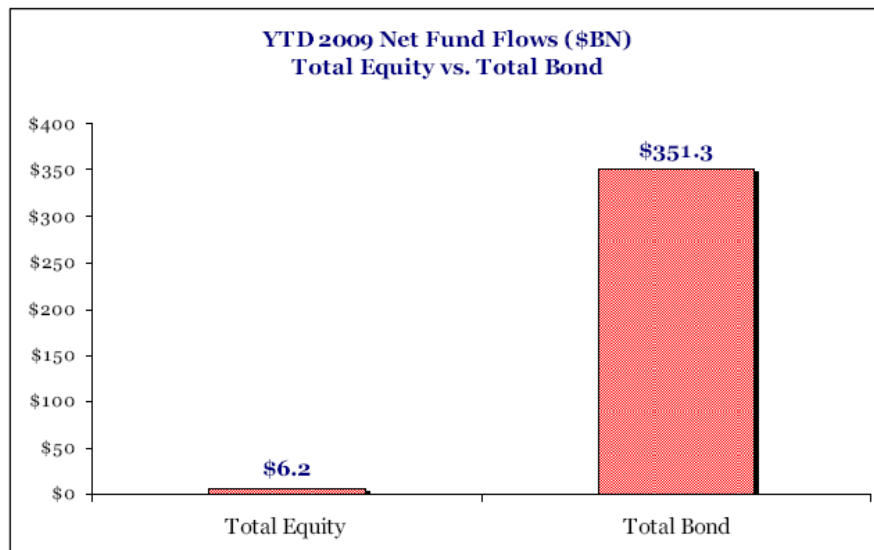
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## We Believe Interest Rates Will Drift Higher

There are competing forces on bond yields, but ultimately, we believe stronger economic growth and future inflation fears will ultimately push interest rates higher. At the end of last year, we moved clients’ fixed income allocations to shorter durations than their benchmarks (around 80% of the benchmark’s duration). This makes fixed income allocations less sensitive to movements in interest rates. Our current taxable fixed income strategy has a duration of 3.4 years, compared to the Barclay’s Intermediate Government/Credit benchmarks duration of 3.8 years. (Duration measures the average number of years of how far a portfolio’s cash flows are in the future, similar to, but not the same as, average maturity.) Current tax-exempt fixed income allocations have a duration of 3.3 years.

The flow of funds data into fixed income over the past year is a bit




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disconcerting. Retail investors have plowed money into fixed income and have ignored equities. While after being trounced by two bear markets in 10 years, there may be a secular sentiment change taking place towards equities, however, such a lopsided allocation of assets often leads to losses.

Historically, the intermediate segment of the yield curve has provided the most return with the least risk. That is the area where we manage client fixed income allocations. We intend to err on the side of caution in terms of interest rate risk and not reach for yield. While adding high-yield bonds would have added a lot of return in 2009, such positions were devastating in 2008. In 2008, our fixed income allocations turned in solid positive return simply by us sticking to our philosophy of conservatism in fixed income investing.

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## Conclusion

We have some visibility into 2010 and believe our current investment strategy makes sense, but believe there will likely be considerable future developments of unknown consequence. As we have said before, flexibility is key. In fact, we adapted to 2009 developments several times to our clients' benefit. We will keep you informed as events dictate.

## Thank You for Your Support in 2009

It has been a little over a year since Independent Portfolio Consultants, Inc. made their proprietary Blue Shores Investment Management Division available to third-party correspondents. Although we started the year from a small base in assets, the asset base has marched significantly higher and we enter 2010 with a swelling pipeline of assets. We thank the financial professionals we work with, and their clients, for embracing our unique approach to global asset management.

We enter 2010 with a very strong team of portfolio managers, research partners, business developers, and operational personnel. We look forward to serving your global investment management needs.

Kevin Bush, CFA, Chief Investment Officer  
Peter McMullin, CFA, Chief Equity Strategist  
Amy Graham, Research Associate

January 8, 2010

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