LPL FINANCIAL RESEARCH

Weekly Market Commentary

February 22, 2010

Investing for Volatility

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

- The volatility and classic 5-10% pullback we have seen so far this year is perfectly normal and very likely to be a recurring pattern throughout 2010 as the economy transitions from recovery to sustainable growth.
- A key contributor to the volatility that accompanied the transition to sustainable growth in 1994 and 2004 was the signaling of rate hikes by the Fed. After hiking the discount rate last week, the market is likely to remain focused on the Fed this week as Federal Reserve Chairman Ben Bernanke will deliver his semi-annual report on the economy and interest rates to House and Senate panels on February 24–25.
- There are several ways to potentially enhance returns during market volatility including: More frequent tactical adjustments to portfolios, focusing on the yield, using active management rather than passive indexing strategies, increase diversification by adding low correlation investments and incorporating non-traditional strategies that help in an environment of increased volatility.

On Friday, the S&P 500 was up 5% from its low for the year on February 8. From January 19 to February 8, the index fell about 8%. Since then, it has recovered more than half of the losses and is now essentially unchanged for the year. The volatility and classic 5-10% pullback we have seen this year is perfectly normal and very likely to be a recurring pattern in 2010.

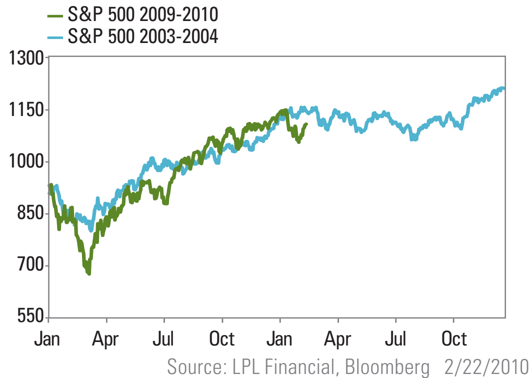
We have often commented that stock market pullbacks of 5-10% are very common and have accompanied every recovery. In fact, this is the third 5-10% pullback during the stock market rally that began in March 2009. During the four and a half year bull market from March 11, 2003 to October 9, 2007, the S&P 500 experienced a 5-10% pullback eight times. However, the volatility in 2010 is likely to be accompanied by a lower return environment than what we experienced in 2009. The environment may be more like that of 1994 and 2004, the last two times the economy transitioned from recovery to sustainable growth.

Both 1994 and 2004 had multiple 5-10% pullbacks in the S&P 500 as the recovery matured, stimulus faded, and the Federal Reserve (Fed) hiked interest rates marking a return to normal conditions. Both years also provided only single-digit buy and hold returns. Just as in 2009, the S&P 500 followed the path of 2003, the stock market in 2010 is tracking the volatile pattern of 2004. [Chart 1]

A key contributor to the volatility that accompanied the transition to sustainable growth in 1994 and 2004 was the normalization of monetary policy—or, in other words, hikes to the Federal Funds rate by the Fed. The volatility began early in those years as the Fed signaled the coming of the rate hikes that took place later in the year. In a surprise move last week, the Fed raised the discount rate (the rate at which the Fed makes direct loans to banks) by 0.25 to 0.75 percent. The Fed stated that the discount rate increase would encourage banks to borrow in private markets rather than from the Fed. In addition, U.S. central bankers closed four emergency lending facilities this month and are preparing to reverse the more than $1 trillion in excess bank reserves they have pumped into the banking system. The Fed noted that these actions represented a "normalization" of lending after providing emergency liquidity since late 2008 rather than a change in monetary policy signaled by a hike in the Federal Funds rate. The message from the Fed repeated that economic conditions warrant low levels in the federal funds rate "for an extended period." Regardless of the Fed's description, these steps toward a return to a more normal lending environment are likely to lead to higher interest rates and tighter credit for banks even without the hikes to the Federal Funds rates, which we do not

1 Volatility Ahead

S&P 500 Index in 2003 – 2004 and 2009 – 2010



Source: LPL Financial, Bloomberg 2/22/2010

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

expect until the second half of the year. For more insight on the Fed's action see this week's Weekly Economic Commentary entitled *Watch Your Step*.

The market is likely to remain focused on the Fed this week, as Federal Reserve Chairman Ben Bernanke will deliver his semi-annual report on the economy and interest rates to House and Senate panels on February 24 – 25. He will probably assure Congress that the central bank is mindful of the lack of job growth in the U.S. and an increase in the Federal Funds rate is not likely to come soon. In fact, last week New York Fed President William Dudley indicated that policy makers need to focus now on maintaining growth rather than fighting inflation, citing a smaller-than-forecast increase in the consumer price index (CPI) for January and the monthly change in the core CPI, which excludes the volatile energy and food components, turned negative for the first time since 1982.

It is relatively easy to figure out how to invest when you believe the market is likely to go up or go down, but how do you invest when it is likely to go both up AND down? There are several ways to potentially benefit from market volatility, including:

- More frequent rebalancing and tactical adjustments to portfolios are recommended to help take advantage of the opportunities created by the pullbacks and rallies. Seeking undervalued opportunities and taking profits are key elements of a successful volatility strategy.
- Focusing on the yield of an investment rather than solely on price appreciation may enhance total returns. High-yield bonds and even stocks such as Real Estate Investment Trusts (REITs) offer a yield advantage over investments that are solely price-driven during periods of high volatility.
- Using active management rather than passive indexing strategies to enhance returns. Opportunistic-style investments provide a wide range of opportunities for managers to exploit during volatile markets.
- Increase diversification by adding low correlation investments and incorporating non-traditional strategies that provide some downside protection, risk management, and help in an environment of increased volatility. These would include investment vehicles exposed to Covered Calls, Managed Futures, Global Macro, Long/Short, Market Neutral, and Absolute Return strategies.

In last week's Weekly Market Commentary, we cited the tailwinds and headwinds for the markets contributing to higher volatility. Some investors are wary of this volatility and view it as a sign of a fragile market. We see volatility as a normal part of the healing process of recovery and a transition to sustainable growth.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability.

Stock investing involves risk including loss of principal.

Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise, are subject to availability, and change in price.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITS involves special risks such as potentially illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Correlation is a statistical measure of how two securities move in relation to each other.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the options.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and make no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit

LPL Financial