

# QUARTERLY UPDATE

Economic and Investment Management Perspectives

FROM THE DESK OF  
**RICHARD GERSHEN**

During the third quarter most equity and fixed income investors enjoyed significant positive returns. The markets’ strong performance reflects improved corporate profitability. Many companies have successfully adjusted to a lower level of economic activity through improved efficiency of operations but sustainable market gains are dependent upon an economic turnaround and the resumption of revenue growth. Overseas, especially in emerging markets, economies have recovered more quickly. Our portfolios reflect improvement in the markets as we have been adding incremental risk on an opportunistic basis. This includes expanding our equity exposure in the broader global markets.

We are pleased to welcome aboard Ron Albahary, who has joined our Convergent Wealth Advisors affiliate as its Chief Investment Officer. Ron is a 19 year industry veteran with a particular expertise in asset allocation, investment strategy and risk management. He will lead Convergent’s 20-person research team, which manages \$10 billion in assets for wealthy individuals, institutions and family offices.

I’m proud to announce that for the ninth consecutive year Barron’s has recognized City National as one of the nation’s Top Wealth Managers, a gratifying affirmation of the talent and dedication of our wealth professionals, as well as the disciplined processes they practice on behalf of our clients.

Since joining City National earlier this year, I have enjoyed meeting with many of our clients. I want you to know that we truly value your insights and overall feedback. All of us at City National are dedicated to serving you and always place your interests first. If I can be of assistance to you in any way, please contact me directly at Rich.Gershen@cnb.com.



*Director of Wealth Management*

## On the Road to Recovery: Lessons Learned

**By Richard A. Weiss**  
Chief Investment Officer  
City National Asset Management

The worst economic recession and bear market since the Great Depression has bequeathed a number of significant lessons. The severe dislocations in the asset markets and near-meltdown of the global financial system has provided us with insights and highlighted weaknesses across the regulatory, economic, financial, political and academic landscape.

Yet a casual observer of the public financial markets might not see these warning signs so clearly. In fact, the sharp reversal in the risky asset markets since March might lull some investors into a sense of imprudent complacency. Based solely on recent trends in returns (see chart below), it may appear as if the markets are now healthy and open for business as usual.

We at City National are less sanguine about the speed of this recovery and continue to caution investors to move slowly and carefully back towards a more fully invested position. Many of the ills that proved nearly fatal to the markets last year are yet to be fully remedied and there is much work to be done. With that said, there are several opportunities for investment that currently present above-average return potential despite the tentative economic recovery.

### Market and Economic Outlook: Goldilocks Redux?

Last year’s severe, and virtually unprecedented, flight to quality has quickly morphed into a race for return. The fear/greed pendulum

has seemingly shifted almost overnight, evidencing a significant increase in risk tolerance from the extreme panic levels witnessed late last year. Higher-risk asset classes are all benefiting from this “flight *from* quality”.

A Complete About-Face in Market Returns?		
	2008	YTD 2009*
Treasury Bonds	13.7%	-3.2
High Yield Bonds	-26.2	46.9
Domestic Stocks (S&P500)	-37.0	20.5
Int’l Stocks (EAFE)	-43.4	29.8
Int’l Emerging Stock Markets	-53.3	64.3
Real Estate (REITs)	-37.3	22.6
Commodities	-35.7	10.1
Hedge Funds	-21.4	8.0
Private Equity	-64.8	33.4

*\*through September 30*

The sharp reversal in the financial markets begs the question of whether it presages a similar turnaround in economic growth. In fact, the market’s recent action is what has prompted many recent discussions on the probability of a “V-shaped” economic recovery scenario.

Surprisingly, although the real economy historically takes much more time to progress (typically several months, if not calendar quarters) – the economic consensus has already begun to mirror the movement in the financial markets. The consensus forecast for real (net of inflation) growth in the domestic economy is now at a relatively healthy 2.5% by yearend. The average growth forecast for calendar year 2010 is also at 2.5%. What is puzzling about these rosy growth forecasts is that both are expected to occur with barely any attendant price inflation. This is the proverbial “Goldilocks” economic scenario.

# Roth IRA Conversion Opportunity

**By Roger Stinnett, CPA, CFP®, CIMA®**  
Tax & Financial Planning Manager

In 2010, the income limitations for Roth IRA conversions will be lifted and taxpayers with more than \$100,000 of adjusted gross income will be able to convert their traditional IRA to a Roth IRA. Here are some conversion Pros and Cons:

## Pros:

- Future tax-free growth and withdrawals – attractive if you believe your taxes will rise in the future.
- No required minimum distributions – attractive if you don't expect to rely on these assets.
- Powerful estate planning tool – allows years of tax-free growth when transferred to heirs.

## Cons:

- Federal and state income taxes will be due on the amount converted, although the tax bill can be spread over 2011 and 2012.
- Roth IRA value could drop substantially after conversion, leaving you with taxes due on the higher amount. However, if this happens, you can re-characterize assets back to a Traditional IRA and eliminate the tax liability.

*Here are some tips to help make a conversion work for you:*

1. Pay tax from non-IRA assets – don't touch the tax-sheltered funds.
2. The longer you leave converted Roth funds untouched the better.
3. Check your overall asset allocation and asset location to ensure that your more growth-oriented assets are in the Roth IRA.
4. Consider harvesting losses in your taxable accounts (if necessary) to raise cash for taxes. Losses can be used to offset gains or carried forward to offset future taxes.
5. Consider a partial conversion for an amount that makes sense for you.
6. Consider multiple Roth IRAs. Set up a separate Roth IRA for each asset class in your asset allocation. This gives you more flexibility by allowing you to re-characterize only the asset classes that have dropped significantly.
7. Undertake tax planning to either defer income from or move deductions into 2011 and 2012, alleviating the tax bite for these years.

Start planning now so that you can make a timely decision early next year – especially if IRAs are still at depressed levels. ❖

*The strategies presented in this document were not intended and cannot be used for the purpose of avoiding any tax penalties that may be imposed. The strategies were not written to support the promotion or marketing to another person any transaction or matter addressed. Before implementation, you should consult with your other advisors on the tax, accounting and legal implications of the proposed strategies based on your particular circumstances.*

## A Road to Recovery

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Within one short year of near economic and financial collapse, the consensus has now shifted to an outlook of healthy economic growth with no inflation.

The Goldilocks economic scenario is doubtful, at best. While we agree with the basic positive trajectory of domestic growth, one of two alternative paths is much more likely: several quarters of sluggish/choppy economic growth, or a return to more normal, healthy growth with an unwanted spurt of inflation.

Thus, we are positioning client investment portfolios to hedge either of these two potential, and more likely, outcomes.

## Lessons Learned?

Although the precise path of this recovery remains to be seen, there are a few things we consider will come out of the events of the past year:

- Broader and tighter regulatory standards, especially in previously under-regulated areas such as hedge funds.
- Requirements for greater equity and liquidity in the banking system.
- Tougher ratings standards in both the corporate and municipal arenas.
- Increased sophistication in risk measurement at all levels. In particular, wider acknowledgement and better understanding of *systemic* risk in the global financial system.
- Higher (not lower) expected returns for common equity to induce investors to accept more risk going forward.
- A discussion in the global economic community about the continued status of the U.S. Dollar as the world's reserve currency, potentially affecting the value and stability of the Dollar over the near-to-intermediate term.
- A clearer understanding by investors of the concept of "Alpha" (or active, "excess" investment return due to skill) versus "Beta" (which is simply the market's average return, and is widely available at low cost).
- Financial theory surrounding the concept of market efficiency more fully embracing the concepts of behavioral finance – which incorporate the emotions and influence of imperfect, and sometimes irrational, human agents and, lastly,
- A fuller understanding and acceptance of the government/business interface – both in academia and the real world. If events of late have taught us anything, they have reminded us that the "free hand" of Adam Smith's in his seminal work, *Wealth of Nations*, is empowered and supported by government.

## Windows of Opportunity

We have been slowly but surely adding incremental risk on an opportunistic basis in many client portfolios. The choppy, but generally upward trending, markets have fortunately afforded us several entry points for investing idle cash.

Specifically, within the context of a well-diversified investment portfolio, we have been adding to both small-cap and international equities. The former to take advantage of attractive pricing and a recovering economy, and the latter as a partial hedge against dollar weakness. Within fixed income portfolios,

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# Positioning for New Opportunities in Equities

**By Barbara Bruser, CFA**

Director of Equities  
City National Asset Management

Equity markets in the U.S. and around the world closed out the third quarter with some of the strongest returns in recent memory. The S&P 500, DJIA, and NASDAQ all returned more than 15.5% in the quarter. For the nine-month period, the NASDAQ is the clear winner, returning 35.6%, versus 19.3% for the S&P 500 and 13.5% for the DJIA. Overseas, the results were even better. Developed markets, as measured by the MSCI EAFE Index, returned 19.5% for the quarter and 29.2% for the nine months; emerging markets, as measured by the MSCI Emerging Markets Index, returned 21% for the quarter and a whopping 64% for the nine months. While these returns benefit somewhat from currency translation, local markets overseas are enjoying a very robust recovery.

## Unusual Sector Rotation Continues

The sector rotation that began in the second quarter continued in the third quarter. Financial services led the pack with a 25% rise in the quarter, followed closely by industrials and materials (both up 21%) and consumer discretionary (+19%). What is interesting to note is that with the exception of industrials, these sectors reported the worst earnings results of the entire market for the same period of time. However, while they may have been the worst, they were actually what investors expected. (The sectors with the best relative earnings performance – utilities, telecommunications, health care and staples – had the worst market returns). We are awaiting the release of third quarter earnings to assess how companies are performing in this environment. If earnings once again show that companies are managing well (i.e. earnings are meeting or exceeding

expectations) and revenues do not collapse there will likely be renewed confidence in the markets.

## Positioning Portfolios for Recovery

The employment, industrial production, and consumer confidence reports released at the end of the third quarter were all less encouraging about the pace of economic recovery but a recovery is still being forecast. Whether it is termed “sluggish” or “jobless” or “U-shaped” or “below normal,” there will be pockets of opportunity for investors and we are positioning portfolios to take advantage of them. During the quarter we began increasing our exposure to small and mid-cap companies that have a tendency to bounce back more quickly when the economy improves. This capitalization spectrum is considered inherently more risky than large-cap companies and does well during periods when investors are *embracing* rather than running away from risk. During late 2008 and early 2009 investors ran away from risk. As 2009 has progressed, investors have been seeking risk and have been well rewarded for doing so.

We are also maintaining our focus on international investments in our equity portfolios. Economies are now more globally integrated than ever and it is appropriate that portfolios reflect that. The U.S. now represents only 36% of the world’s equity market capitalization. Thirty five years ago the U.S. represented 64% of the world’s equity market capitalization. While Western Europe, Japan, and other developed markets have increased in importance and value, the big story is the rise of the emerging markets. These markets did not exist thirty five years ago. Today they represent almost 15% of the world’s equity markets. We continue to believe that international diversification in an equity portfolio both manages risk and enhances the opportunity for return. ❖

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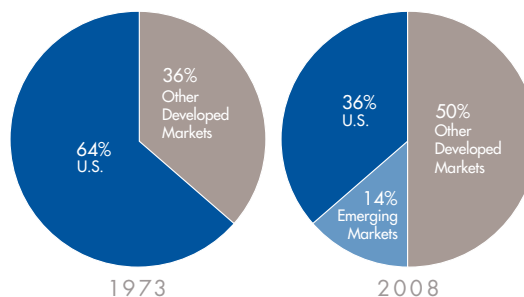
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## THE GROWTH OF GLOBAL MARKETS

### Equity Market Capitalization

Source: Datastream



# Bond Investors Pursuing Risk Again

**By Rod Olea**

Director of Fixed Income  
City National Asset Management

Bond investors are weighing a number of seemingly contradictory signs. On one hand, we have historically low yields in short-term U.S. Treasuries due to a weak economy and accommodative monetary policy. Yet, paradoxically, prices of riskier securities such as investment-grade corporate bonds and high-yield debt skyrocketed in the first nine months of the year (+17% and +50%, respectively). Meanwhile, Treasuries are down -2.3% for the same period.

The outsized returns of lower grade bonds would not be unusual in a pronounced economic recovery, but they are surprising given today's tentative economic fundamentals and constricted lending standards. It's a bit unnerving to realize that corporate yields spreads over Treasuries are narrower than they were in the spring of 2008 as the financial meltdown began with the collapse of Bear Stearns.

Municipal bond investors also face conflicting signals. Most cities, counties and states are experiencing the worst budgetary crises of a generation as tax receipts continue to decline due to sharp revenue shortfalls. However, absolute and relative yields (municipal yields versus yields on Treasuries) are at or below historic lows, signaling a significantly more bullish environment ahead. Leaving fundamentals aside for the moment, demand for tax-exempt bonds has far outstripped supply, pushing the absolute yield levels for municipal bonds past 40-year lows. It looks like technical market conditions are outweighing credit fundamentals once again. Yields on lower quality issues have already come off their lows as evidenced by the recent severe re-pricing of the new California General Obligation offerings in October. We remain very patient in this richly priced environment and are focusing on bond valuations in the 4-8 year area as we selectively put money to work.

The budget woes of California and New York may be off the front pages this week, but California's financial problems have not gone away. Politicians have simply postponed the structural budget issues while revenue shortfalls continue to mount. However, as mentioned in our last Quarterly Update, the debt servicing of California's General Obligation debt ranks second in priority payments and remains a suitable investment for most clients, even with BBB average ratings and changing valuations.

## Municipal Bond Strategy

The municipal bond market had exceptional returns for the third quarter as demand for tax-exempt paper overwhelmed supply and drove yields lower. Investors currently have to go out beyond two years to capture yields above 1%, because most short-term bonds remain anchored by low Treasury yields. We are positioned slightly longer than our respective benchmarks due to the steep yield curve. Our focus is still on essential purpose revenue bonds such as water, power and sewer bonds (50% allocation), General Obligations (GOs) of cities and states (35%), and pre-refunded bonds backed by government securities (15%). We remain about 30% allocated out of state for both our California and New York clients to maintain diversity in this weak economic environment and keep yield on parity after-tax. We maintain our high quality orientation, as evidenced by our AA average quality. To increase yield in our portfolios, we have been selectively adding cushion callable bonds (bonds that have an attractive yield to either the call or maturity, along with a higher coupon to protect against extension risk). We are also keeping a tight band on the call/maturity range to better control interest rate risk in the future.

## Taxable Bond Strategy

Risk management remains paramount as we examine corporate bond valuations in this uncertain economy and credit environment. We have reduced our overweight in financial corporate bonds by moving some of our exposure to shorter maturity issues and taking other measures that should enable us to protect corporate valuations if credit spreads erode from current levels. Our sector allocation remains nearly unchanged at 45% investment grade corporate bonds, 25% government agency issues, 15% U.S. Treasuries and 15% U.S. agency Collateralized Mortgage Obligations. We are maintaining our neutral duration/maturity stance because we anticipate little if any increase in interest rates for most of next year as the Fed holds to its current policy.

We are not yet ready to re-position our portfolios for an inflationary environment but when we believe deflationary influences have passed, we will move to protect clients against inflation through a combination of exposure to Treasury Inflation Protection Securities (TIPs), international bonds and shorter maturity bonds. ❖

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## On the Road to Recovery *Continued from page 2*

our previous emphasis on taking more credit risk has paid off handsomely for many clients as yield spreads continued to narrow. Currently, we remain neutral with respect to average maturity/duration in deference to higher interest rates down the road. Lastly, for many clients whose risk tolerance permits, we have small slivers of commodity and other alternative asset exposure. ❖