Fourth Quarter 2011 Market and Performance Update

By: SEI Investment Management Unit

Summary

- **Ongoing eurozone troubles undercut optimism, but strong economic data releases from the U.S. boosted sentiment.**

- **Equity and fixed-income markets gained, with risky assets among the strongest performers.**

Stock and bond markets generally rallied in October, declined in November and were mixed in December. The quarter began on a strong note as reports that the eurozone was working on a plan to restructure the European banking sector and positive U.S. economic data releases helped to foster an optimistic mood. At the end of October, a new rescue plan for Greece was released. Despite this, investor confidence faltered toward the end of the month when concerns over the European debt crisis intensified. This negative sentiment continued throughout most of November, but the markets rallied again toward the end of the year. News of combined action on behalf of some of the world's leading central banks intended to help ease the spread of the sovereign debt crisis in Europe was announced and once again boosted confidence levels. Troubles in the eurozone dominated the headlines for much of the period, but positive economic data releases from the U.S. helped ease investor fears.

Economic Backdrop

The October agreement aimed at preventing the Greek crisis from spreading required banks holding debt in the troubled country to accept a 50% loss on their returns and to raise more capital as protection against losses from other potential government defaults. It was also announced that the European Financial Stability Facility (EFSF, the eurozone's main bailout fund) would be boosted from €440 billion to approximately €1 trillion. At the end of October, concerns over the European debt crisis intensified as these efforts did not create a lasting calm in the markets.

The U.S. Joint Select Committee on Deficit Reduction, or the "Super Committee," was set up in August to establish a plan to reduce the U.S. budget deficit by $1.2 trillion within 10 years. The failure to do so by the November 21 deadline led to a series of automatic spending cuts (which are scheduled to be implemented in January 2013).

Globally, the year ended on a positive note. The central banks of the U.S., the U.K., the eurozone, Japan, Canada and Switzerland unveiled a joint plan to help shore up the world's financial system, which came into effect on December 5. Under the program, commercial banks will be able to purchase U.S. dollars more cheaply, enabling them to have access to funds more easily. The news was welcomed by investors and helped to buoy sentiment as the year drew to a close.

Positive economic news from the U.S. throughout the period helped boost confidence that a recession in one of the world's leading economies could be avoided. U.S. inflation, as measured by the Consumer Price Index, fell to 3.5% in November. In the same month, retail sales recorded their largest rise in close to two years, driven partly by large numbers of purchases made on Black Friday. Unemployment figures were particularly encouraging, and U.S. consumer confidence levels also showed signs of improvement.

Market Impact

Fixed-income assets that are perceived to be riskier performed best during the quarter, largely driven by optimism in October. High-yield bonds did particularly well, followed by emerging markets debt. Global government bonds, especially those for troubled eurozone countries, fell out of favor. Yields for Greece and Italy rose throughout the period and Italian bond yields rose above 7%. This prompted speculation that Italy could be the next country in need of a bailout. The European Central Bank attempted to ease the situation by purchasing Italian and Spanish government bonds and this, combined with change in political leadership (particularly in Italy) provided some comfort to market participants. The government debt of Portugal was downgraded to "junk" and 15 eurozone nations were put on negative watch by Standard & Poor's.

Volatility slowed throughout the period, as a degree of calm returned to the markets. Global equity markets benefited from this, notably in October, although equity returns began to stagnate somewhat in the final weeks of the year. However, for the quarter as a whole, cyclical sectors (which are sensitive to economic fluctuations and tend to do poorly when confidence is low and economic contraction is anticipated) performed well, with Energy and Industrials recording the highest returns. Rising oil prices helped to push the Energy sector higher. Despite strong performance in October, Financials struggled for the rest of the quarter as investors turned their attention back to the debt crisis in the eurozone.

Index Data

- The Dow Jones Industrial Average index gained 12.78%.
- The S&P 500 Index advanced 11.82%.
- The NASDAQ Composite Index increased by 8.21%.
- The MSCI AC World Index, used to gauge global equity performance, gained 7.18% in the fourth quarter of 2011.
- The Barclays Capital Global Aggregate Index, which represents global bond markets, rose by 0.23% over the quarter.
- The Chicago Board Options Exchange Volatility Index (VIX), a measure of implied volatility in the S&P 500 Index that is also known as the "fear index," fell from 42.96 to 23.40 during the quarter.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, rose from $79.20 a barrel at the end of September to $98.83 by December 31.
- The U.S. dollar strengthened against most currencies during the quarter, while the euro weakened. The U.S. dollar fell marginally against the Japanese yen, but gained against the euro and sterling. The U.S. dollar ended the quarter at $1.55 against sterling, $1.30 versus the euro and at 76.94 yen.

Portfolio Review

SEI's equity portfolios generally benefited from the sharp rally in U.S. equity markets during the fourth quarter, despite the fact that market momentum stalled later as the European sovereign debt crisis intensified. In large-cap equity, strong stock selection, particularly within Information Technology (IT) and Health Care, overcame subpar sector allocation decisions. Small-cap equity saw strong stock selection in addition to favorable sector weightings contribute to performance. In international equity, stock selection in Japan helped returns, but was offset by negative selection impacts from Pacific ex-Japan and Europe.

SEI's fixed-income portfolios posted positive performance during a quarter in which rates ended largely unchanged and spread sectors staged a mild comeback. In core fixed income, an overweight to agency mortgage-backed securities was a positive contributor due to security selection and tactical positioning. An underweight to banking and financial services helped results in high-yield bond, as both underperformed due to concerns about the global financial system in the event of a sovereign default for European periphery countries. In emerging-markets debt, selection to corporate credit in China benefited from an improvement in liquidity.

Contributors

- Stock Selection in Large-Cap Equity – *picks within Health Care and IT contributed significantly to results*
- Health Care Holdings in Small-Cap Equity – *company-specific performances were beneficial, especially within the pharmaceutical segment*
- Sector Allocation in International Equity – *an underweight to Financials offset the effects of an underweight to Consumer Staples*
- Overweight to Venezuela in Emerging Markets Debt – *this country's bonds were supported by higher oil prices*

Detractors

- Core Managers in Large-Cap Equity – *their performance was hindered by positions in Energy, Financials and IT*
- Consumer Discretionary in Small-Cap Equity – *stock selection was negative in media, services and retail*
- Defensive Posture in High-Yield Bonds – *this detracted from relative returns during the strong months of October and December*
- Allocation to Corporate Debt in Emerging Markets Debt – *local currency debt was also marginally negative*

Manager Positioning and Opportunities

SEI's portfolio managers aim to provide diversified sources of excess return for our portfolios through solid investment-manager selection and portfolio construction. In large-cap equity, managers believe that macro events and subsequent volatility will continue to shape the landscape over the next few quarters, and are overweight to IT and Consumer Discretionary. In small-cap equity, there is a significant overweight to the Industrials sector in the capital goods segment, specifically machinery. International equity managers have increased the overweight to Materials and Telecom, while retaining the overweight to Industrials and IT.

In investment-grade fixed income, spread sector allocations have been and continue to be focused on the securitized sectors, as they represent the greatest fundamental relative value. High-yield debt managers are maintaining an allocation to bank loans due to their more defensive positioning and event-driven opportunities. In emerging-markets debt, managers will continue to utilize performing corporate credits and allocations to local currency debt and FX for diversification and relative return enhancement despite the potential for greater volatility.

Our View

We no longer favor stocks over bonds, but rather have a neutral perspective. Within equities, we favor a tilt toward U.S. large-company stocks. U.S. economic activity has rebounded, although the overall growth outlook remains moderate at best. We favor the U.S. versus international equities as the debt crisis in Europe continues to spread, resulting in a slowing of growth in the core economies of Europe and near or outright recession in the debt-burdened periphery countries. The economic and financial problems in Europe could harm the growth prospects of emerging-market exporters. We favor high-yield fixed income versus investment-grade fixed income. Bond markets have exhibited surprising resilience. While U.S. Treasurys continue to be viewed as a safe-haven play by investors whenever market turmoil intensifies, in our view, relative-value opportunities are more attractive in the high-yield space (although the ride has become bumpy in recent months).

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