

As Fed Chairman Bernanke said, these are unusually uncertain times. Stocks should do well if the economy perks up while bonds should do well if the economy rolls over. We're agnostic between these opposing scenarios. The most rational, prudent strategy then is to hedge portfolios for either outcome.

Market Overview: Unusual Uncertainty

As you may recall, in the second quarter of 2010 the S&P 500 fell 11.43%. We're happy to report that in the third quarter the S&P turned on a dime and rose 11.29%. We wish we could give you a good reason for this turn of events.

Perhaps the best explanation comes from Fed Chairman Ben Bernanke, who in testimony before Congress stated that the current economic climate was characterized by "unusual uncertainty." As the Fed Chairman's words are parsed obsessively by investors around the world, you can be sure Bernanke chose his words carefully. By invoking and emphasizing the concept of "uncertainty," Bernanke made a bold, if somewhat technical statement.

For economists the concept of "uncertainty" is distinct from that of "risk." Risks are possible outcomes whose probabilities can be determined with some degree of accuracy. Risks can be managed. Uncertainty rather describes possible outcomes of indefinite or incalculable probability. Uncertainty is very hard to manage.

What we've seen from both the markets and the headlines is a reflection of this state of uncertainty. One quarter the market's down 11%, the next quarter it's up 11%. One day the fear among investors is inflation, the next day it's deflation. In April the concern was over how the Fed would exit its stimulus measures and so avoid over-stimulating the economy. Today all the talk is of "QE2," short-hand for a second round of Fed stimulus in the form of "quantitative easing," that seems required to keep a faltering economy afloat.

You want to ask: Well, which is it? The answer, unfortunately, is that nobody knows and trying to assign probabilities to the competing outcomes is like drawing lines in water. Which is why, after all its gyrations, the S&P is up less than 4% so far in 2010.

Portfolio Strategy for Uncertainty

Before going into depth on the economic and market outlooks, we should underline that uncertain times like these warrant a less committed, more cautious portfolio strategy. Consequently we've gradually been moving portfolios into a more hedged, defensive posture: lowering equity exposure and increasing bond holdings.

Per our comments above, these moves are not about being "right" in the sense of predicting a particular outcome and committing portfolios accordingly. Rather these moves are about being *safe* and hedging portfolios against an uncertain future.

Stocks should do well if the economy perks up while bonds should do well if the economy rolls over. We can make an argument for either scenario but are agnostic between them. Consequently the most rational and prudent strategy is to hedge portfolios for either outcome.

Economic Overview: Different This Time

These are unusual times. The economic and market dynamics at play are unlike other post-WW II recessions and recoveries. Those were all largely "managed" by the Fed through its monetary policy—raising interest rates to cool the economy (often unintentionally inducing recession) and lowering them to warm it back up (fostering recovery). This time is different.

Today the Fed has held short-term interest rates near 0% for going on two years without convincingly fostering a sustainable recovery. Indeed, the US economy expanded at a 5% pace in the fourth quarter of last year, a 3% pace in the first quarter of this year and a 1.7% pace in the second quarter. The trend isn't going in the right direction. Why?

continues on reverse

Major Market Performance 2010

	3rd Quarter 2010% chg.	1st 9 mos. 2010 % chg.
DJIA	11.13	5.57
S&P 500 (large cap)	11.29	3.89
S&P 1000 (small/mid cap)	12.05	10.69
S&P 1500 (all cap)	11.39	4.67
NASDAQ	12.30	4.38
Barclays State G.O. Municipal Bond	3.46	7.11
Barclays Gov/Credit Intermediate Bonds	2.76	7.44

Economic Overview: Different This Time (cont'd)

Following other post-WW II recessions the Fed lowered interest rates, which lowered lending rates across the economy, which in turn spurred consumer borrowing that funded increased spending most notably in the housing sector. The pick-up in spending and housing activity led to job creation, which led to more spending, etc., creating a positive feedback loop that pulled the economy out of recession. Not so this time.

While the Fed has taken interest rates to historic lows and with them mortgage and other lending rates, consumers are NOT increasing their borrowing. Indeed, just the opposite. Consumers are paying down debt—"deleveraging"—rather than increasing it. As a result, consumer spending has remained tepid, the housing market quite weak and unemployment quite high.

In short, consumer deleveraging has broken the transmission mechanism by which the Fed's monetary policy worked on the economy in the past. The result is a Fed whose monetary exertions are like "pushing on a string."

The New Normal

Bill Gross and Mohamed El-Erian, Co-CEOs of bond manager PIMCO, have argued that this process of consumer deleveraging is going to be with us for a while. As it took consumers over 20 years to build up their current crushing debt burden, working it down to more sustainable levels will likely take a while as well.

How long? While nobody really knows, all the informed answers we've seen have been put in terms of years: two, five, ten. The point is that we should get used to the idea that consumers—not only in the US but across the developed world—will be a bit distracted from their spending for a while. And when consumers are distracted from spending by saving, consumer-driven economies like the US don't grow as fast as they otherwise would.

Gross and El-Erian suggest that such a subpar economic climate will, indeed, become "the New Normal" for developed economies. They further argue that corollary to this subpar economic climate is a subpar investment environment with returns constrained by sluggish sales and profit growth.

Our Take

It's good to keep in mind that PIMCO is a bond manager and the scenario its CEOs are forwarding is favorable for bonds. But we do nonetheless think they have a point. It stands to reason that if rising consumer borrowing over the past 20 years created a tailwind for the US economy, the process of unwinding that debt should create something of a headwind. And it should do so for a while.

This does put income-paying investments of all stripes in a more favorable light, whether bonds or dividend-paying stocks (e.g., REITs, utility and preferred stocks). For, all else being equal, a slow-growth environment will hinder investments whose return is driven largely by price appreciation.

But we should keep in mind that the deleveraging process is focused in developing economies—primarily the US, the UK, and Europe. There's a lot of world beyond these regions. And the emerging markets of China, India, Brazil, South Korea *et al* are not only high-savings, low-debt economies they are also growing at a much faster pace than developed economies. For firms that are either based in or at least selling into these economies, their stocks' appreciation needn't be limited by the growth rates of developed countries.

This poses a particular challenge to socially responsible investors because social research on firms in emerging economies isn't as broad or as deep as it is for firms in the US or Europe. Furthermore, investing in Chinese firms often means investing alongside the Chinese government, as it holds stakes in many of the largest Chinese companies. Social investors' attitudes about such a partnership are likely to be complicated.

Be that as it may, at Trillium we are actively exploring ways to provide our clients equity exposure to emerging economies while honoring our commitment to responsible investing. As these markets assume an increasingly large role in the global economy and do so as its fastest growing region, it behooves us to find ways to participate.

Farnum Brown
Chief Investment Strategist

Social Advocacy Highlights

Target: An Aptly-Named Company

In August, the state filings of a front group known as MN Forward revealed that **Target**, **Pentair**, **Best Buy** and ten other Minnesota-based corporations were very large donors to the organization, which describes itself as pro-business. MN Forward then directed those funds to candidates including the Republican gubernatorial nominee for Minnesota, Tom Emmer. But far from improving the business environment in the land of lakes, the donations quickly prompted a nationwide boycott and extensive media coverage. Emmer, it seems, is extremely right wing; his staunch opposition to gay marriage and equal parenting rights for same-sex couples ignited protests from the LGBT (lesbian, gay, bisexual and transgender) community as well as MoveOn.org.

The donations took advantage of new rights granted to corporations by the Supreme Court in its *Citizens United* decision, which repealed significant previous restrictions on corporate giving to political recipients. Joining with our friends at Walden Asset Management and the Calvert Group, Trillium quickly filed shareholder resolutions at Target and Best Buy calling for a review of “the criteria used for such contributions and the broader impact contributions may have on the company’s reputation, public image with consumers and business sales and profitability, including how hoped-for benefits are balanced with the broader costs of endorsing a candidate whose policies may conflict with Best Buy’s publicly expressed values.”

The resolutions piggyback on a multi-year shareholder campaign that has pushed for increased transparency, oversight and accountability of corporate political contributions. In just a few years, responsible investors have used dialogue and shareholder proposals to persuade over half of the S&P 100 to adopt best practices in this area, disclosing not only their donations to candidates, but also their payments to trade associations (for example, the U.S. Chamber of Commerce, a huge player in this year’s elections) and gifts to groups such as MN Forward.

The backlash against Target and Best Buy created a huge media buzz (*Los Angeles Times*, *CNBC*, *Reuters*, *AP*, *New York Times*, *CBS Market Watch*, *Minneapolis Star Tribune*, *Huffington Post* and numerous bloggers) during the news-starved month of August. To our great fascination the story continues to have legs as right wing commentators use it to accuse the left of intolerance.

We write this in the immediate wake of a *Wall Street Journal* op-ed and a Bill O’Reilly diatribe against any who would admonish companies to remain true to their values (Target, Best Buy and **3M**, which piled on with a MN Forward donation in September, all have excellent benefits and nondiscrimination policies in place for their LGBT workers), choosing to portray us as attacking Target for purely partisan reasons. The truth is that if we “went after” all the companies in our portfolios who sometimes gave to Republicans, we’d never have time to do anything else.

Let’s be clear: Tom Emmer is a pretty special guy. His campaign made a donation to a “Christian hard rock ministry” that chided American Christians for not having the guts to call for capital punishment for gays as is done in some parts of the world.

Investor’s Business Daily forwarded a more amusing theory. It seems Trillium is a shill for the unions who targeted Target because its workforce is non-union. This must be so, said the paper, because we have “former AFL-CIO employees on [our] payroll.” To the best of my knowledge, none of our employees have a union background, not -- as Jerry Seinfeld would say -- that there’s anything wrong with that.

The debate will continue, perhaps, because by the time you read this, we will have filed similar proposals at Pentair and 3M. Let us be perfectly clear: this isn’t ultimately about partisanship, union sympathies or gay rights. It’s about getting companies to understand that when you underwrite a candidate, you are literally supporting all of their campaign positions. And the more controversial those positions are, the more risk of backlash from stakeholders whether they are Democrats, Republicans, Tea Partiers or Greens.

So the question for corporations then becomes: Is it ultimately worth it?

Shelley Alpern

Director of ESG Research and Shareholder Advocacy