# Al Frank Asset Management

## Strategy Review & 2011 Outlook

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# January 26, 2011

# Strategy Review & 2011 Outlook

***Transcript from January 26, 2011.***
***Recording available at*** http://www.alfrank.com/files/_system/File/AFAM_Value_Strategy_Call.mp3

Good afternoon, and welcome to the Al Frank Asset Management Strategy Review and 2011 Outlook Presentation.

My name is Mike Jacque and I am the private client director for Al Frank Asset Management. Today, I am joined by Chief Investment Officer, John Buckingham and Portfolio Manager and Vice President Jason Clark.

John and Jason are going to offer a review of the general markets and our all-cap equity value strategy, as well as discuss our outlook for 2011.

Before I hand the call over to John, I would like to offer the following disclosures. During this call, we will be discussing prior period performance. As a reminder, PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Listeners can learn more about our managed accounts as well as their long-term performance figures and important disclosures by contacting us for a fact sheet. Indices are mentioned for comparison purposes. They are unmanaged and it is not possible to invest directly in an index. Stock recommendations we discuss may not be indicative of the results for all recommendations and there is a risk of loss.

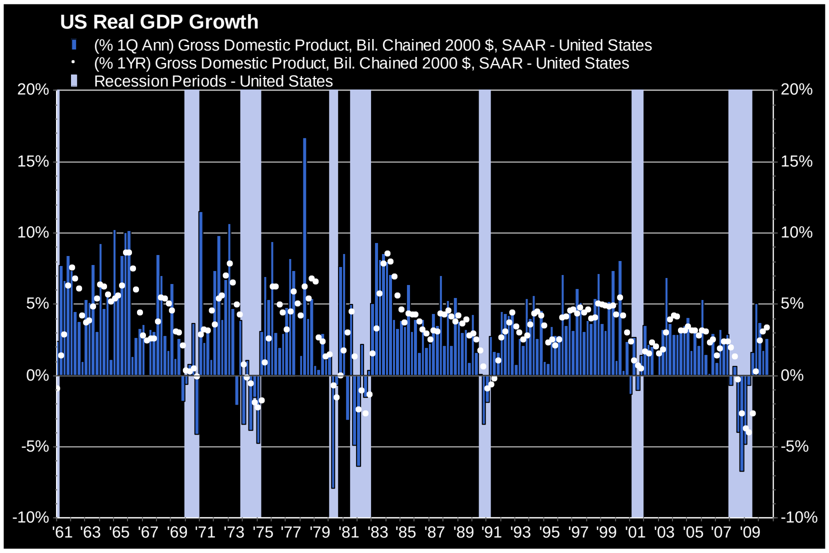
With that said, John.......

## Market Review

While we will also provide plenty of commentary, most would agree that a picture is worth a thousand words and our Strategy Review and 2011 Outlook call is decidedly a multimedia affair this go-round so we encourage listeners to follow along with the accompanying slide presentation.

Looking back at 2010, we suspect that many were surprised by the magnitude of the gains, given all of the talk of the 'new normal' environment in which returns were supposed to be subdued going forward. Although history has proved time and again that economic downturns and recessions have always given way to upturns and expansions…

## THE ECONOMY
## 50 YEARS OF RECESSIONS & EXPANSIONS




*Source: FactSet Research Systems*

…it was not easy to remain upbeat, given the signs of the times…

## INVESTORS WERE FEARING GREAT DEPRESSION II OR SOMETHING EVEN WORSE!



…and 24/7 media coverage where just about anything qualified as BREAKING NEWS…

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## A SENSATIONALISTIC MEDIA DIDN'T HELP



As the drama unfolded Thursday afternoon, the cable news networks logged ratings roughly double their usual averages, according to the Nielsen Co. Some of the coverage was deemed so crucial it aired without commercial interruption.

…while those peddling financial advice played heavily on the first of the twin emotions of fear and greed that seem to drive so many investment decisions.

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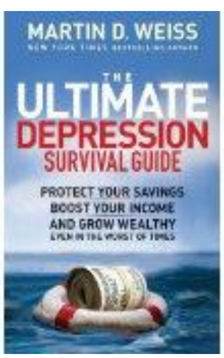
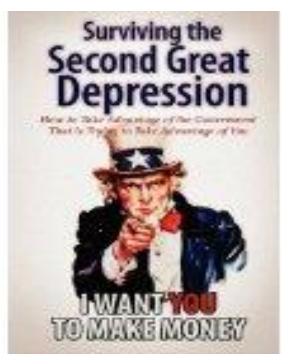
## FEAR AND GREED

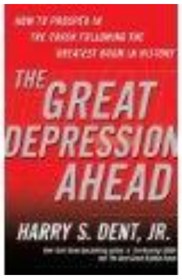
Signs of the Times - 2009.



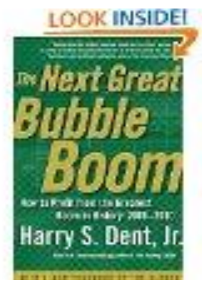




We think investors should cast a skeptical eye at what they find on the financial best-seller list for it is generally reflective of what has already taken place and is not necessarily valuable in predicting what is to come.

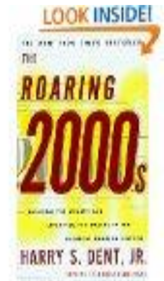
## FEAR AND GREED
Signs of the Times – Harry S. Dent Through the Years.




2009




2004



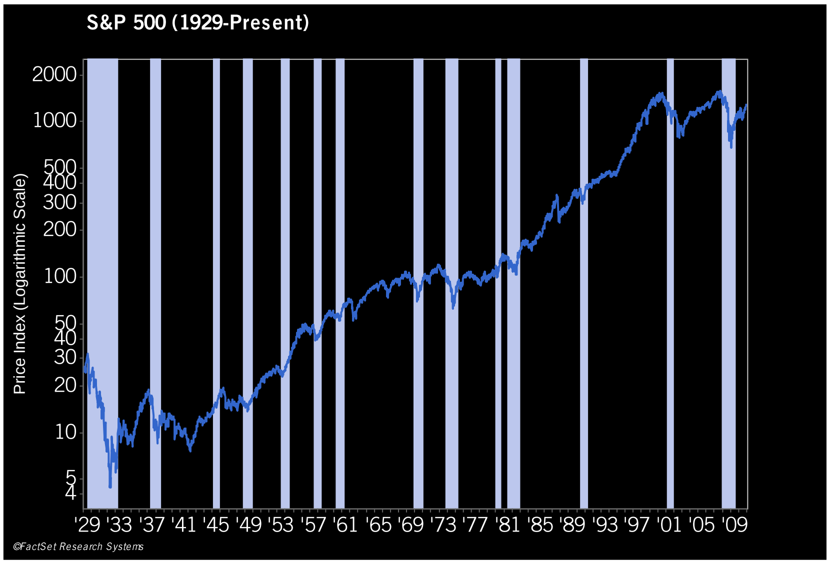

1998

Though unprecedented action from Congress and the Federal Reserve, not to mention central bankers around the world, undoubtedly played a major role, Great Depression II was averted and the equity markets rebounded mightily off of the March 9, 2009 lows…

## …AND YET, HISTORY REPEATS…
Stocks have soared since the March 2009 lows.


…as has occurred throughout market history...

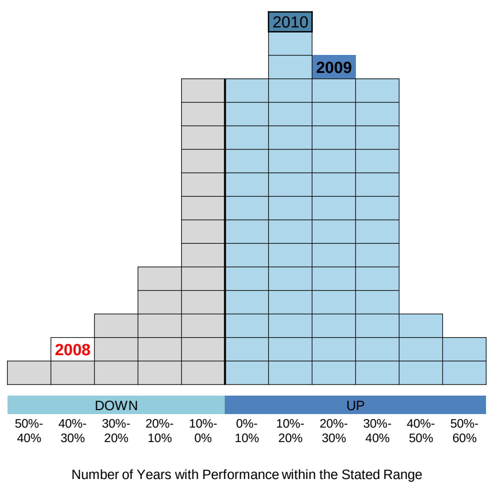
## ...AS IT HAS TIME AND TIME AGAIN.




...though returns have hardly been uniform through the years.

## U.S. EQUITIES—RETURN DISPERSION

Percent change in the S&P Market Index by year since 1926




By year 1926 through 2010. Past performance does not guarantee future results. SOURCE: Al Frank and FactSet Research Systems

Of course, history has shown that for those with a long-term time horizon, equities have been the place to be...

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## HISTORICAL EVIDENCE
Stocks have performed well since 1926…

**Wealth Indices of Investments in the U.S. Capital Markets**
**Effect of $1.00 Invested at Year-End 1925 & Annualized Return**

| Small Company Stocks | Large Company Stocks | LT Govt Bonds | T-Bills | Inflation |
|---|---|---|---|---|
| $12,230.87 | $2,591.82 | $84.38 | $20.53 | $12.05 |
| 11.9% | 9.8% | 5.4% | 3.7% | 3.0% |

From December 31, 1925 through December 31, 2009. Hypothetical investment assumes the reinvestment of dividends and capital gains. Past performance does not guarantee future results. SOURCE: Morningstar *Stocks, Bonds, Bills and Inflation Classic Yearbook* – Pages 25 & 28.

…with the kinds of value-priced stocks that we generally favor showing better performance over the past eight decades than their more expensive growth-oriented peers.

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## HISTORICAL EVIDENCE
…and Value has outperformed Growth.

**Performance of Fama-French Value & Growth Stock Series**
**Effect of $1.00 Invested Year-End 1927 & Annualized Return**

| FF Small Value | FF Large Value | FF Small Growth | FF Large Growth |
|---|---|---|---|
| $44,193.48 | $5,148.46 | $1,156.83 | $930.61 |
| 13.9% | 11.0% | 9.0% | 8.7% |

From December 31, 1927 through December 31, 2009,. Hypothetical investment assumes the reinvestment of dividends and capital gains. Past performance does not guarantee future results. SOURCE: 2010 Morningstar *Stocks, Bonds, Bills and Inflation Classic Yearbook* - Pages 102-103. Fama-French uses all stocks traded on the New York Stock Exchange (NYSE) to set both growth/value and small/large breakpoints. They then apply these breakpoints to all stocks traded on the NYSE, NYSE/AMEX and NASDAQ to construct each index. Median market capitalization is the reference point for small/large while book value of equity divided by market capitalization (higher for value, lower for growth) determines the classification category.

Now to be fair, many stock market pundits were actually upbeat in their prognostications for 2010, with Bloomberg reporting in December 2009 that 1223 on the S&P 500 was the average estimate of 10 brokerages for the year-end target, but all of the money that was shoveled into bond funds and out of domestic stock funds throughout much of the year suggested that few were ready to re-embrace equities.

Guess the consensus isn't always wrong as the S&P 500 actually ended 2010 at 1257, with the total return for that widely-followed market gauge coming in at 15.1%! Of course, the year was hardly uneventful as the rally came despite May's frightening 'Flash Crash', the seemingly constant worries over European sovereign debt, the on-again/off-again fears of monetary tightening in China and concerns that weak labor and housing markets would push the U.S. economy back into recession. Though the volatility seen throughout much of the year compelled more than a few investors to lighten their equity exposure, those who stayed the course and remained focused on their long-term investment objectives generally were well rewarded for their patience. Keeping in mind that past performance is no guarantee of future results, the well-known Dow Jones Industrial Average had a total return of 14.0% and our Russell 3000 benchmark index returned 16.9%, while most of our diversified all-cap equity portfolios beat those numbers and our less-volatile, larger-cap, dividend-oriented portfolios turned in solid performance.

Jason Clark will now discuss some of the reasons why our portfolios performed as they did. Jason…

## Sector Review – Jason Clark

I'll first provide a brief overview from a sector and market-cap perspective and then talk a little about the two individual positions that had the largest impact on performance during 2010.

During 2010, we generally benefited from better stock selection relative to the Russell 3000 within Information Technology, Health Care and Materials, while also realizing relatively better returns from slightly underweight positions and relatively better stock selection within the Consumer Discretionary and Financial sectors. An underweight position in and relative underperformance from Utilities pulled down aggregate portfolio performance during 2010. In addition, our relatively better stock selection within the Telecommunication and Consumer Discretionary sectors could not overcome our underweight position relative to the benchmark, and therefore negatively affected relative performance.

Looking at capitalizations, generally better stock selection within micro, large and mid-cap names lifted relative performance versus the Russell 3000 for the twelve-month period. In addition, a material underweight position within giant-cap names and relatively poorer selection in the small-cap space negatively impacted 2010 performance.

Those that had the opportunity to participate in our mid-year call last July may remember that we highlighted Anadarko Petroleum (APC). We believed that the shares of Anadarko had undergone a dislocation from the fundamentals due to the Deepwater Horizon disaster in the Gulf of Mexico, of which APC was a 25% passive owner. During this period, APC traded down to 1 times book value, and we thought that there existed a high probability that the company would avoid the large majority of major penalties because of reckless actions taken by BP in designing and operating the well. Although we acknowledged the elevated risk, we believed that in the fullness of time investors would again be rewarded as the company began to be valued for its deep and diverse exploration and production portfolio that had made it one of the sector darlings before the Gulf spill. During mid-June we began purchasing shares of Anadarko and have an average cost of approximately $43 per share. During 2010, Anadarko was one of our top performance contributors as the shares traded above $76 at year end. We are still holding our APC today.

Not all of our 2010 holdings served us well.  During the first 5 1/2 months of 2010, our Alcoa (AA) stake decreased in value by almost 30%. At that time, we still believed that the aluminum giant would benefit from the forthcoming rise in global expansion, however, we were growing increasingly concerned about management's ability to effectively execute and our analysis suggested that that there were better opportunities elsewhere in the materials sector. As such, in mid-May, we sold our stake in Alcoa and used the proceeds to pick up shares of Freeport McMoran Copper & Gold (FCX), which was then trading in the mid-$60s. At that time, we viewed Freeport's valuation as quite attractive, given that the stock had plunged from the mid-$80s price at which it had been trading in April and we were positive on the outlook for both copper and gold. Freeport shares closed 2010 trading above $118.

While we could spend the better part of a day talking about 2010, we suspect that there is even greater interest in our outlook for 2011. As such, I'll turn the call back to John.

## 2011 Outlook – John Buckingham

Thanks Jason. Most market watchers are expecting 2011 to be a good year. Given our emphasis on bottom-up individual stock selection and our oft-stated belief that the only problem with market timing is getting the timing right, we aren't in the business of guessing where the market will end 2011. However, returns a little better than the previously mentioned 9.8% to 11.9% per annum over the past eight-plus decades for U.S. stocks (as calculated by Morningstar's Ibbotson Associates) would not be surprising, again keeping in mind that the past is never a guarantee of future performance.

Of course, we can't ignore the fact that investor sentiment gauges like the Bull/Bear Survey from the American Association of Individual Investors are flashing warning signs from a contrarian perspective with many more bulls than bears than is usually seen.


Souse: AAII – Consumer Sentiment Survey, January 24, 2011

However, we just are not seeing a lot of enthusiasm toward domestic equities from mutual fund investors…

## MARKET OUTLOOK 2011
### …but they're not really buying U.S. Stock funds.

Investors are not exactly pouring money into U.S. stock mutual funds.

**Estimated Flows to Long-Term Mutual Funds**

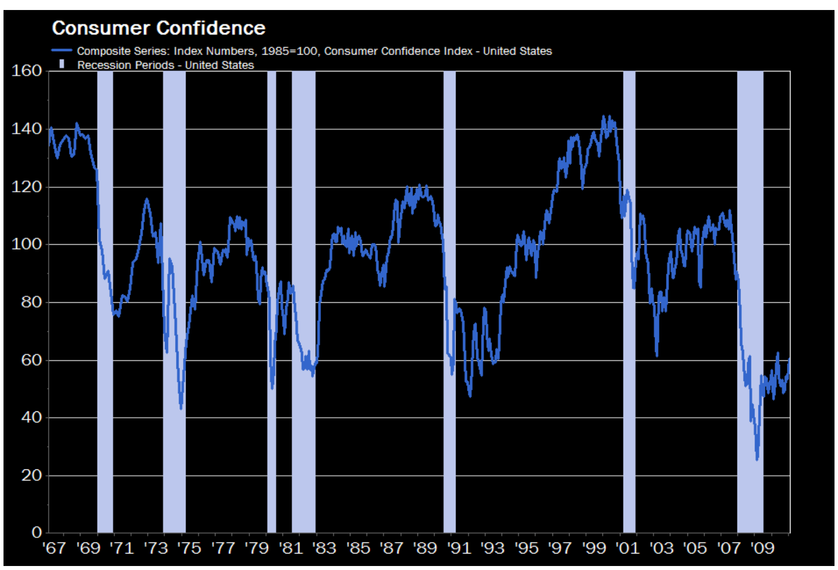
*Millions of dollars*

| | 12/15/2010 | 12/21/2010 | 12/29/2010 | 1/5/2011 | 1/12/2011 |
|---|---|---|---|---|---|
| Total Equity | -163 | 3,284 | 2,724 | -1,812 | 6,540 |
| Domestic | -2,395 | -419 | 434 | -4,229 | 3,765 |
| Foreign | 2,232 | 3,703 | 2,290 | 2,416 | 2,775 |
| Hybrid | 381 | 1,586 | 1,049 | 549 | 2,140 |
| Total Bond | -8,621 | -4,514 | -447 | 532 | -980 |
| Taxable | -3,762 | -965 | 2,387 | 2,679 | 1,388 |
| Municipal | -4,859 | -3,549 | -2,833 | -2,147 | -2,368 |
| **Total** | **-8,403** | **356** | **3,326** | **-731** | **7,700** |

*Source: Investment Company Institute*

…and Main Street is far more pessimistic than usual…

## MARKET OUTLOOK 2011
### And Main Street is down in the dumps…




*Source: FactSet Research Systems*

…as the current 9.4% unemployment is hardly inspiring.

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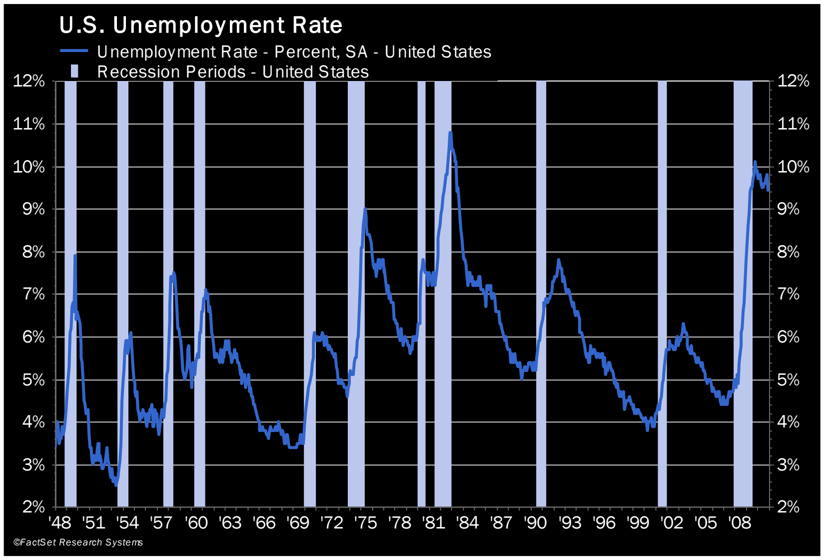
## MARKET OUTLOOK 2011
...as the unemployment rate is up above 9%.




Investors still have plenty about which to be concerned…

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## MARKET OUTLOOK 2011
There are plenty of things to worry about…

**Budget Deficit**
**Tax Policy**
**Legislative Unknowns**
**Banks Under Pressure**
**Housing in the Dumps**
**Commercial Real Estate**
**PIIGS**
**Dollar Volatility**
**Interest & Inflation Rates**


PIIGS is an acronym for a group of countries that include Portugal, Italy, Ireland, Greece and Spain

…but historically low inflation and interest rates, the former actually too low for some deflation-fearing tastes and the latter no doubt held down by a very accommodative Federal Reserve,…

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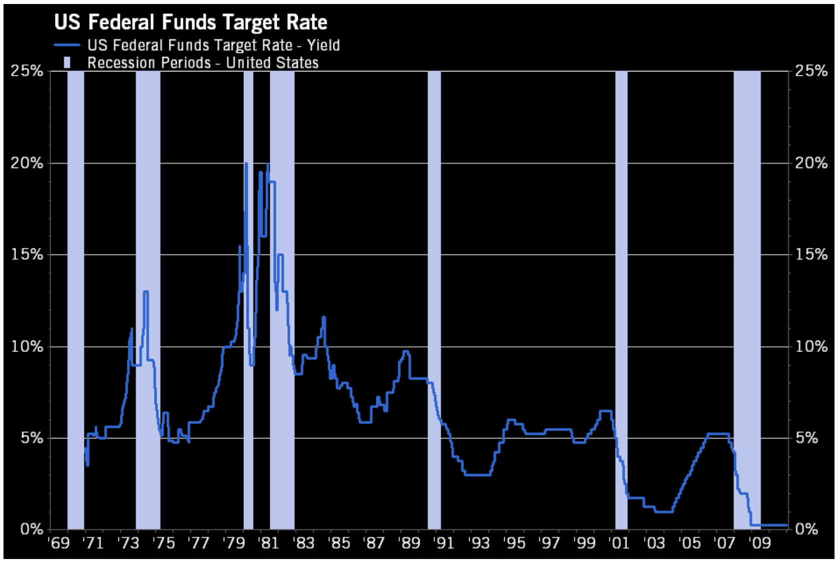
# MARKET OUTLOOK 2011

## But an accommodative Fed has kept rates low…




*Source: FactSet Research Systems*

…make stock extremely attractive based on the so-called 'Fed Model'. No doubt, the Fed Model has its flaws as it was suggesting that equities were attractively priced heading into the 2008 meltdown, but the valuation tool suggests that the yield on the 10-Year U.S. Treasury should equal the earnings yield (the inverse of the P/E ratio) on an equity index like the S&P 500. When the earnings yield is higher than the Treasury yield, as it is today, stocks are thought to be undervalued, and vice versa.

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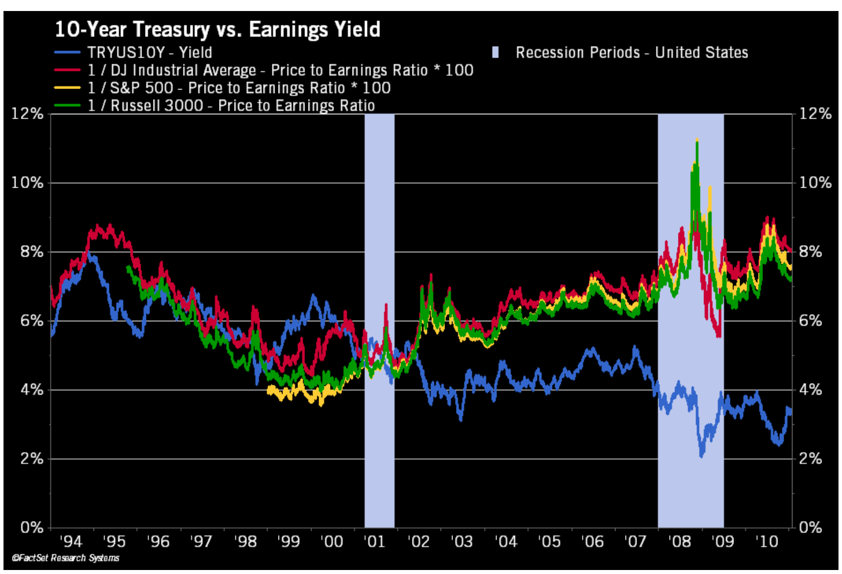
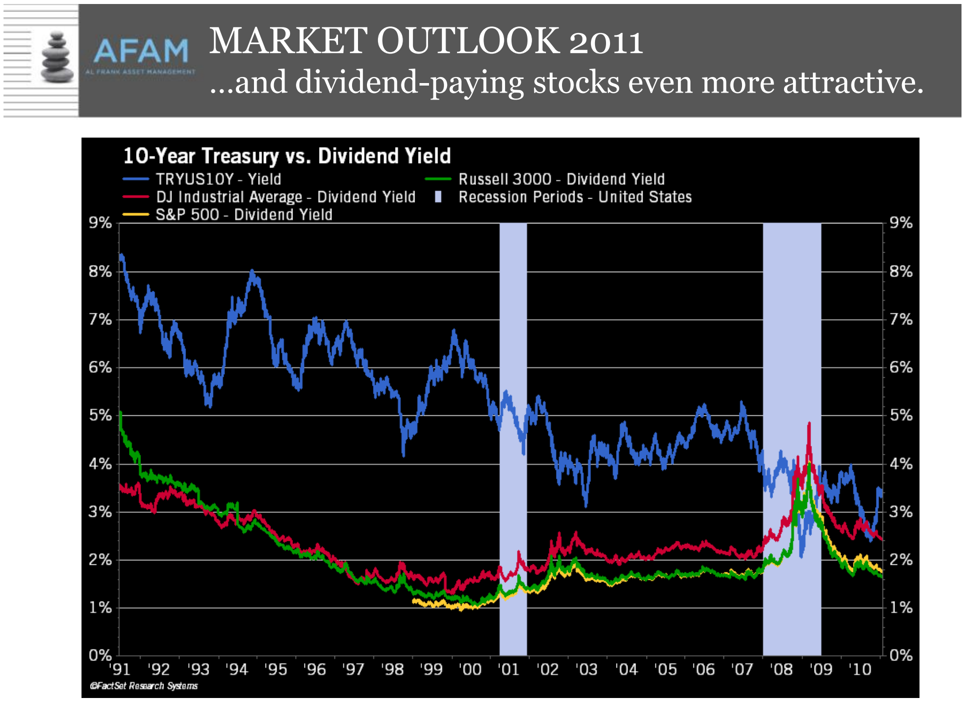
# MARKET OUTLOOK 2011

## …making stocks generally relatively undervalued…

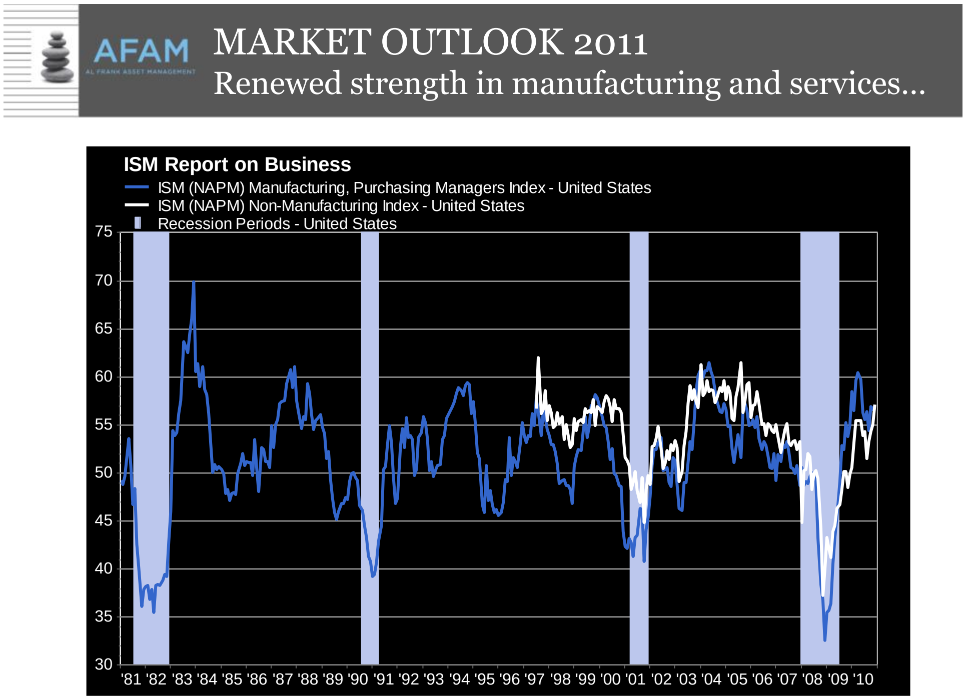


Of course, a more traditional comparison would be between Treasury yields and dividend yields, with the latter especially appealing in our view in today's low interest rate environment.



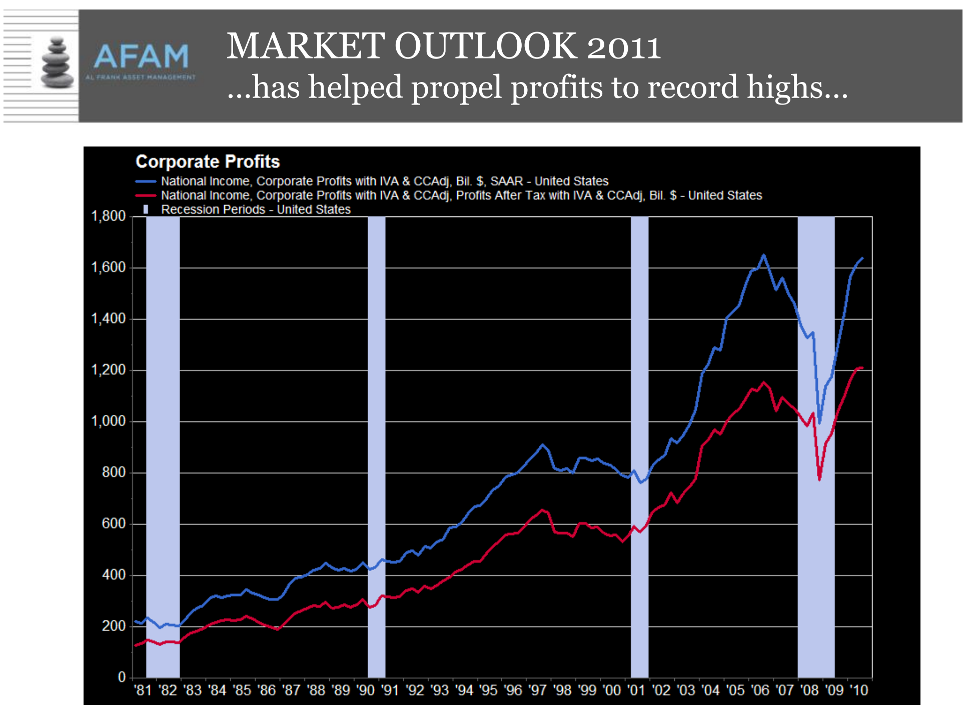

Looking at the prospects for economic growth, which are undoubtedly helped in the near-term by QEII, Federal Reserve Chairman Ben Bernanke recently stated, "Overall, the pace of economic recovery seems likely to be moderately stronger in 2011 than it was in 2010. We have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold." Also, the head of the U.S. Chamber of Commerce Thomas Donohue said last week, "The state of American business is improving. Last year, we worried about a double-dip recession. Today, we are cautiously optimistic that the recovery will continue and pick up steam as the year progresses." And the Blue Chip Economic Indicators consensus of 50 forecasters believes that U.S. GDP growth will now be a little better than previously thought at 3.3% in 2011, with 3.2% the early estimate for 2012.

It is difficult to characterize the economy as strong, especially as both the Blue Chip projections (the unemployment rate is projected to be 9.1% by the fourth quarter of this year and 8.4% by fourth quarter 2012) and Mr. Bernanke ("It could take four to five more years for the job market to normalize fully") are sober in their expectations for the labor picture. Still, we can't ignore favorable recent statistics from the Institute for Supply Management (ISM)…




*Source: FactSet Research Systems*

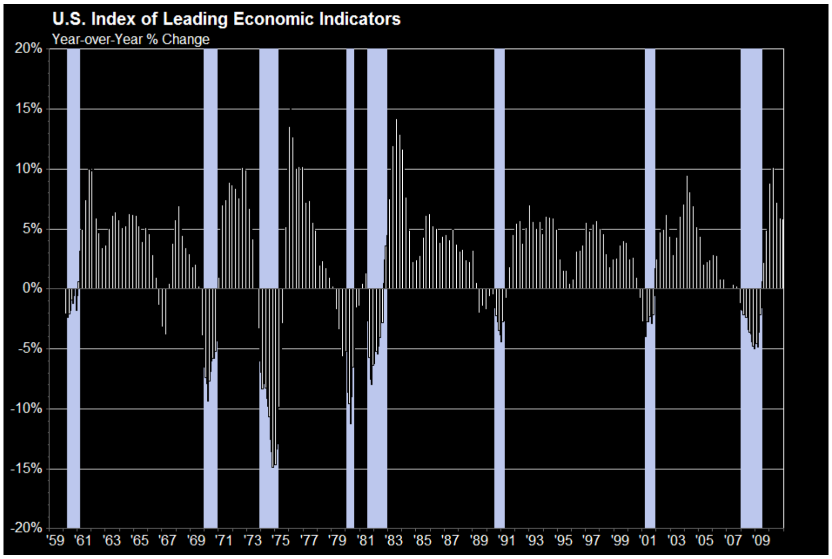
…nor can we forget that corporate profits (pre- and post-tax) are at all-time highs on an absolute basis…




*Source: FactSet Research Systems*

…or that the latest read on a widely-followed gauge of future economic activity just surprised to the upside…

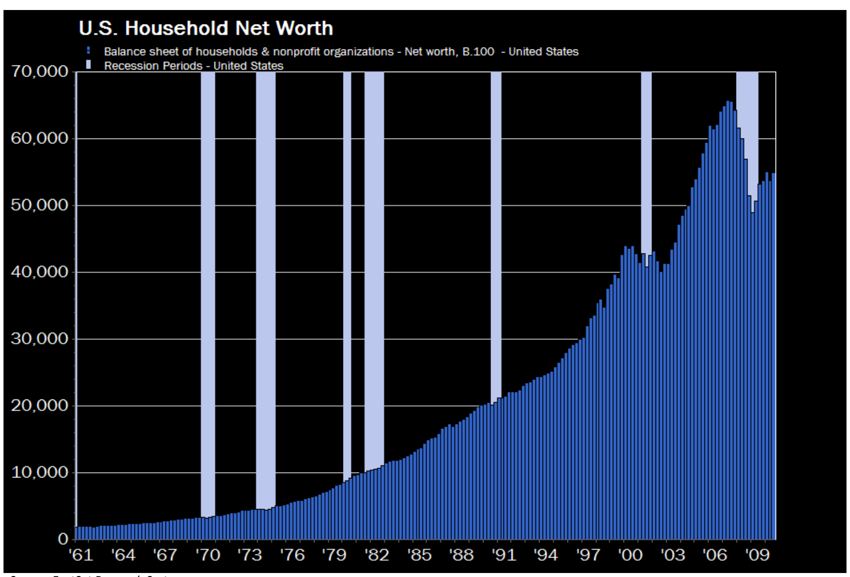
## MARKET OUTLOOK 2011
### …and economic growth looks likely to continue…




*Source: FactSet Research Systems*

…which should continue to help consumers rebuild their personal balance sheets, allowing greater consumption and investment in the future.

## MARKET OUTLOOK 2011
### …further mending personal balance sheets.

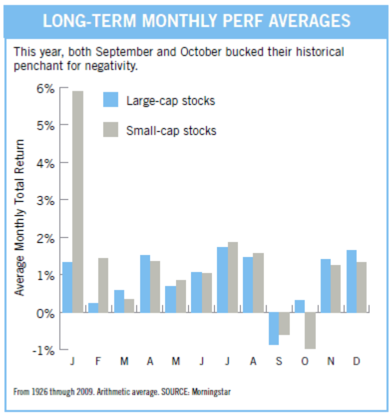


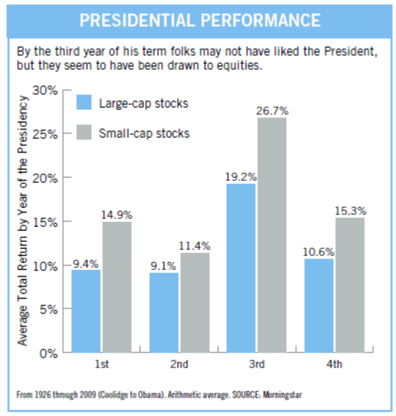

*Source: FactSet Research Systems*

In addition to having seen the uncertainty over the extension of the Bush tax cuts alleviated, we have also just entered the historically-favorable third year of the presidency…

## It's a seasonally favorable time…

Most historical analyses will show that stocks are usually place to be (September is actually the only month of the year, on average, that large-caps have lost ground), but the 3rd and 4th years of the Presidency have been the best of the four-year cycle.




…and we are pleased with what we are hearing from Corporate America. In addition to a significant pick-up in M&A activity, and a healthy dose of dividend increases, the National Federation of Independent Business said its small-business optimism index hit its highest level since December 2007, while the Business Roundtable (a group of CEOs of large corporations) reported that optimism among its members rose to the highest level since early 2006. Also, we just learned that the fourth-quarter poll by the National Association for Business Economics (NABE) found 42% of a diverse group of companies interviewed are looking to increase hiring in the next six months, up from 29% at the beginning of last year, with only 7% saying that they plan to cut jobs. "It looks like the opening melody of a true recovery in the labor market," said the chairman of the committee that conducted the NABE survey.

Obviously, we'd like to see improved top-line growth and an eventual increase in hiring, but strong corporate profit margins and generally healthy balance sheets keep us excited in the interim.

Certainly, the road ahead will not be without a few potholes and we look for volatility to remain elevated. As such, we think that active investment strategies, especially those biased toward value, will outperform passive approaches.

## MARKET OUTLOOK 2011
but stock picking matters…

**INDEX & SECTOR METRICS**

We're bottom-up stock pickers, but there are valuation differences to consider across the Russell 3000's three subsets and 10 sectors.

| | Div Yield | Price/ Earns | Forward P/E | Price/ Book | Price/ Sales |
|---|---|---|---|---|---|
| **Index** | | | | | |
| Russell 3000 (All) | 1.7% | 15.9 | 13.7 | 2.1 | 1.3 |
| Russell Top200 (Large) | 1.9% | 14.3 | 12.7 | 2.1 | 1.4 |
| Russell MidCap (Mid) | 1.4% | 18.4 | 15.3 | 2.1 | 1.3 |
| Russell 2000 (Small) | 1.2% | 26.0 | 18.7 | 1.9 | 1.2 |
| **Sector** | | | | | |
| Energy | 1.6% | 15.2 | 13.3 | 2.1 | 1.3 |
| Materials | 1.5% | 19.5 | 14.3 | 2.8 | 1.4 |
| Industrials | 1.7% | 19.2 | 14.8 | 2.6 | 1.1 |
| Consumer Discretionary | 1.2% | 17.6 | 15.1 | 2.7 | 1.1 |
| Consumer Staples | 2.8% | 16.0 | 14.1 | 3.3 | 1.0 |
| Health Care | 1.8% | 14.6 | 11.6 | 2.5 | 1.3 |
| Financials | 1.6% | 14.0 | 12.5 | 1.2 | 1.3 |
| Information Technology | 0.8% | 17.2 | 13.8 | 3.4 | 2.4 |
| Telecom | 4.6% | 14.6 | 14.7 | 1.9 | 1.2 |
| Utilities | 4.1% | 12.8 | 13.0 | 1.4 | 1.1 |

As of 12.31.10. SOURCE: FactSet Research Systems

Active topped passive in 2009 and 2010 and we think that stock picking matters even more today, especially as equities are no longer universally undervalued.

## Closing

On behalf of the Investment Team and the entire AFAM staff, I would like to thank you for your time and remind you that if you have any questions, please contact us by phone at 888.994.6827 or email us at info@alfrank.com. And for those interested in additional information about our private client managed account offerings, please contact me directly at 408.310.8081 or mike@alfrank.com.

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**Market Commentaries**


**The Prudent Speculator**

**Disclosures**

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*The Hulbert Financial Digest performance results are calculated by undisclosed methods of the publication's editor. Its rankings are based on an average of its several portfolios (and includes discontinued portfolios).*

*The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.*

*The Standard & Poor's 500 Stock Index is generally representative of the U.S. Stock Market, without regard to company size.*

*The S&P Mid Cap 400 provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.*

*The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.*

*The Dow Jones Industrial Average serves as a measure of the entire U.S. market, covering such diverse industries as financial services, technology, retail, entertainment and consumer goods.*

*It is not possible to invest directly in an index.*

*Investment recommendations are subject to change and may result in a loss.*

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