For the purposes of this note, I am defining, "A New Bull Market," as a market which reaches levels higher than the market high before the 2008-2009 crash. The purpose of this note is to raise the possibility that this new bull market is, in fact, underway. I'm not smart enough to predict that outcome with "certainty" but I want to be useful enough to raise the possibility while there is still time to benefit from it.

On February 2, 2009 I gave a speech to the "Managed Accounts Technology & Operations Summit" on behalf of Asset Management Finance which began with the following:

"My talk today is about the importance of, and ways of achieving and maintaining, money manager independence. But before I dive into that, given the current economic and financial crisis, I think I need to express my view of the future business and investment environment. After all, we are not going to have a flourishing, or perhaps even viable, investment management industry unless the economic and financial background upon which the industry depends is healthier than it was in 2008 and is currently.

"We are clearly "coming off" a 10 to 15 year period of increasing leverage in the U.S. (and in fact the world) economy. It was also a period of diminishing regulation of financial markets. Now excessive regulation of any market clearly suppresses creativity and growth. But I think we have found (always the hard way) that as we approach no, or negligible and ineffective, regulation the result is a tendency of red blooded humanity to operate with excessive animal spirits and unrestrained short term self-interest. This is often dangerous, destructive and not in the interests of the greatest social good.

"Today, in order to correct these problems of excess, we are embarked, as a society and as an economy, on a great experiment in economic and, yes, social, engineering which is informed by a vast amount of scholarship, investigation and prior experience but is still not a sure bet, either conceptually or politically.

"But I believe that we have arrived at a remarkable juncture of recognized crisis, political consensus and technique development that can and should produce more or less the desired outcome. That outcome should be a moderately resurgent U.S. economy and better than moderately resurgent markets.

"To be sure, we are going to have to deal with the effects of deleveraging for several years to come as the superleveraged, pro-risk environment of the last decade is brought down to earth. That should dampen the growth rate in the economic recovery but it need not dampen the growth rate of the markets as higher PE ratios, connoting higher quality earnings, appear on the investment horizon.

"I, for one, feel that we will recapture the market losses of the last six months much more rapidly than might now be imagined because of this quality of earnings/lower leverage combination as 2009 and 2010 unfold. On the other hand, we do run a longer term inflation risk as we apply vigorous fiscal stimulus in the presence of much enhanced liquidity (and its accompanying extremely low interest rates for qualified borrowers). I also expect housing volumes and eventually, to some extent, prices to recover as qualified home buyers find extremely attractive financing options available.

"In this setting, stock prices should recover and the money management industry should prosper once again if, and for as long as, inflation stays under control. The trauma experienced by the industry in 2008 should bring about some changes, however. One of the changes I do <u>not</u> expect is the dissolution of the hedge fund industry or even the seemingly derivative "fund of funds" industry. I do think, however, that the liquidity problems which have always been present in private equity investments and were unexpectedly present in some hedge funds will be more of an issue.

"By and large, the average hedge fund declined much less in 2008 than the average long only manager. That was to be expected. But how then explain the greater fear of redemptions being felt by many hedge fund managers? The basis for this fear seems to lie somewhere in the gap between actual performance and client expectations, in client composition, and in fee structures and unexpected liquidity issues.

"In my view, the greatest reality check for today's sophisticated institutional investors (read large endowments and foundations) has been the shocking impact on their operations of the illiquidity of wide swaths of their portfolio holdings. I predict a profound movement over the next several years by these institutions to improve the marketability of their portfolios. We are already seeing attempts by some of them to sell, even at deep discounts, some of their non-marketable securities.

"Therefore, I think one of the characteristics of the resurgent money management industry of the next several years will be a much greater preference by clients for liquidity (or ready marketability) in portfolio holdings.

"A second characteristic is likely to be sharply reduced use of leverage in investments and portfolios, if for no other reason than that leverage on a scale comparable to the recent past will not be available from banks and other, now chastened, lenders.

"But professional money management isn't going away. There is simply too much accumulated capital in the hands of institutions and high net worth individuals (not to mention 401(k) and mutual fund holders like the rest of us) which needs to be productively managed. There is no alternative. In the present and forthcoming low interest rate environment for "safe" investments, which is being created by the Fed, professionals who offer a reasonable expectation of much higher returns will be as much needed as ever."

<u>I think this is a reasonable way to begin this message</u>: At this point in the evolution of the market and the economy I believe the monumental uncertainty and risk which we were facing late last year and early this year has been much reduced by the natural progress of the business cycle aided substantially by the activities of the Fed and moderately by the fiscal stimulus provided by the Administration.

As a consequence, I believe it is now timely to consider a more positive scenario for the economy and stock market. Consider the following:

1. Many of us have been trained over a long period of time to believe that one of the most significant drivers of the stock market is Federal Reserve monetary policy. The Fed's aggressive provision of liquidity to the economy and the market has seemed to me to offer a much more profound and immediate impact on the stock market than it may have on the economy itself.

2. The expansion of liquidity which has been undertaken by the Fed in the last nine months has, I believe, been far and away the greatest in the history of modern finance. The tripling of the Fed's balance sheet which has occurred since last summer is, I think, completely unprecedented and can be seen as most likely very definitive in its impact on the markets.

3. Because of the extreme trauma of the economic collapse of last September and October, it could well be as much as two to three years before this profound money supply growth translates into unacceptable levels of inflation. This grace period could well be further enlarged by the enormous growth in supply occasioned by the dramatic increases in output from China and other developing countries.

4. Some of the same negatives that played into the horrifying risks in the recent decline could automatically be interpreted as positives if they appear to be on the way to correction. For example, the remarkable leverage in the economy of the past ten years is being unwound. The price bubbles in housing and certain commodities have been deflated. The preference for illiquid and other hard-to-value or sell investments has been significantly moderated. Many of these changes could be seen as justifying higher PE multiples on liquid equity investments.

5. A slow and tempered recovery in the economy is often not bad news for the stock market which has traditionally been willing to look ahead toward long-term prospects and is prepared to discount them well before they actually happen.

6. The very persistence of high levels of joblessness has been seen from only one perspective: restraint on demand. But it could also be seen from a perspective of rising efficiency and rising profit margins for manufactures and others in the recovery.

Consequently, it would be quite possible for investors to see a recovering economy, significant increase in liquidity, substantial fiscal stimulation, reduced leverage, reduced excesses and improved profit margins. All of this could encourage optimism with respect to future levels of economic activity accompanied by much higher PE multiples. Suddenly the problem is transformed into the solution and for some months or even a few years, the market is off to the races.

Finally, I ended my February 2 presentation with a forecast of certain investment management industry changes which I see for the future:

1. More but, hopefully, <u>wiser regulatory protections for investors</u>. Not guaranties against losing their money. These are, of course, impossible. But protections against many types of fraud, excessive use of leverage and non-transparent illiquidity.

2. <u>Limitations on the use of certain types of "toxic" derivatives</u>. Banning derivative products willy nilly would, of course, be absurd. Many provide useful hedging opportunities, especially to professional investors and traders. But the use of nuclear armed, highly leveraged instruments in cases where a more public participant is ultimately at risk will become unacceptable.

3. <u>A decline in the use of leverage in portfolios</u>. In many cases most of this leverage has been invisible from the surface view of the clients. It has been deeply imbedded in underlying investments and sub-portfolios. These instruments will be reformed and "tamed" to reduce their potency if things go wrong. This will, of course, reduce the positive impact when things go right. But that will be deemed to be an acceptable tradeoff.

4. <u>Greater portfolio liquidity</u>. This is a pet peeve of mine. Early in my career as a money manger, I took over a fund which held a meaningful percentage of private placement fixed-income securities. The conclusion which I and my bosses reached was that the inability to dispose of these holdings when we chose to was worth more than the somewhat higher current returns they produced. Our conclusion was to sell them.

   Beginning 20 years ago or so many endowment and foundation clients became convinced that accepting illiquidity in investments was an acceptable trade off for higher returns. At that time it was, and they were rewarded. But now, and with much less leverage available to private equity investors, the worm seems to have turned. The private equity game has become tougher and the rules have changed. Greater liquidity in investments will be more prized in the future.

5. <u>More regard for "black swans" and "fat tails</u>." Probably the biggest investment story of our time is that just because a sequence of events has low probability doesn't mean it can't happen. The biggest stories of 1998 and 2008 were probably that the unexpected can, and eventually will, happen and portfolios need to have enough resilience built in to survive these events periodically. Not in someone else's lifetime but in ours.

6. Finally, candor and evenhandedness was too often suspended in the recent bull market for money management talent. I believe in this talent, but I worry that the quest for outsized rewards for successful managers has led to overpromising in the interests of extracting higher fees. The result may be what we have now. Hedge fund managers, by and large, performed pretty well in 2008 but their promises were for even better performance (in order to justify ever higher fees?) and those even better results didn't happen. The future will require more candor and more reasonable rewards for the new breed of managers.

All of these reforms could be seen as contributors to a healthier and therefore more valuable investment universe. More encouraging evidence of a strong environment for equities.

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