Quadrant ASSET MANAGEMENT

QAM Update
May 2012

The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

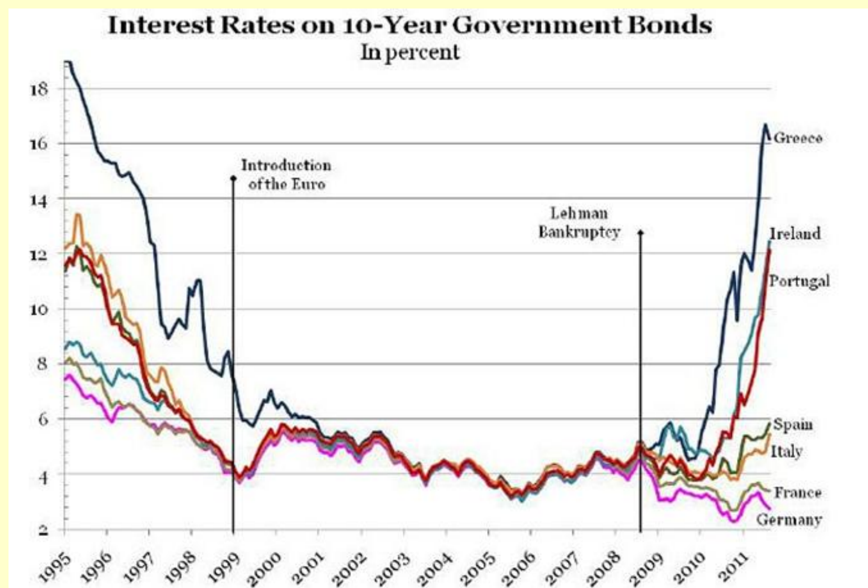
"Wisdom outweighs any wealth" - Sophocles

A Greek Tragedy

As the world looks at the political events in Greece like they were part of one of the famous Sophocles' tragedies, there seems to be not enough wealth let alone wisdom in the area.

For almost a decade, European politicians made the case that Eurozone countries were all the same. All countries with one currency and one Central Bank would have the same credit risk. So investors (and banks) lent funds to the weaker Eurozone countries, driving borrowing costs (bond yields) for those countries down. Far too often, perception is everything in the world of finance. The creation of the Euro meant for many that sovereign risk was the same across all countries despite the differences in culture, regulations and fiscal behavior.

The financial crisis of 2008 affected the world economy with deficits and debt levels of different Eurozone countries being hit in diverse ways. Bond markets reacted correspondingly, and this little graph that was very popular among financial circuits last year tells the story best. Interestingly enough, for the most part, the same countries with high yields before the introduction of the Euro saw their bond yields spike after the financial crisis. In the words of Warren Buffet, people only find out who is swimming naked when the tide goes out.



Source: Thomson Reuters DataStream

Given the developments and the political pressures mounting in Europe, we are in the presence of a scenario where the probability of one or more countries leaving the Euro is clearly higher. In regards to Greece in particular, some analysts stopped asking "if" and are now asking "when". But breaking up (or holding the fort together) is never easy to do, so we think that we are in the presence of a new series of disorganized development in the Sovereign Debt Crisis in Europe as opposed to a controlled and fluid environment.

Despite the fact that Greece is only a small fraction of the Eurozone and a minuscule part of World GDP, we believe that if Greece actually leaves the Euro or defaults on its debt, strong negative sentiment could drive markets to overshoot to the downside with no regard for long-term valuations. This will represent a buying opportunity for common shares of quality companies.

We are seeing the impact of this negative sentiment on the markets with North American markets having lost close to 6% in May and almost 10% since they peaked in early April. Despite the fact that we are all bombarded with news and commentary on the situation in Europe, we believe that some denial of the reality remains and further market reduction will occur if the "blood actually runs in the streets" (or parliaments in this case).

Valuations, in the end, will prevail and if markets do turn further south because of the Greece syndrome just like last summer, the prices of risky assets will climb back in a matter of months.

QAM adheres to a strategic asset allocation methodology based on diversification across different asset classes tied to a client's ability to take risks. As part of maintaining the risk/reward balance within each portfolio, we will rebalance the portfolio based upon market tolerances around the core target asset mix.

By mid-May QAM analyzed the current events and decided that even though the situation didn't warrant an underweight of equities and risk assets, it certainly didn't encourage an overweight in equities.

We continue to make sure all portfolios are within the equity targets, however, in light of the ongoing erosion of sentiment and the almost daily change in market direction, we have relaxed our minimum tolerance on equity targets somewhat.

We will continue to monitor developments through mid-June (elections in Greece take place) or a full correction of the market (traditionally defined as 20% drop from the peak). Once there is more clarity surrounding the political challenges and fiscal imbalances in Europe (and the U.S.), that could even involve another round of Quantitative Easing, then we will narrow our rebalance tolerances to take advantage of good valuation levels. Equities still represent good value; they will represent even better value in the future if prices decline further due to this increased level of anxiety.

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