ALAMAR
CAPITAL MANAGEMENT

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The first quarter brought with it more good news for equity investors. With a 12.6% return for the S&P 500 in Q1, the bull market now stretches into its $4^{th}$ year. Alamar was pleased to see our All Cap Strategy outperform in the quarter with a 15.8% return. Our portfolio of stocks has now achieved an annualized return of 23.2%, before fees, since inception (Jan 1, 2010), compared to a 13.2% return for the S&P 500. On a cumulative basis we are up 60% while the S&P500 is up 32%. Importantly, we have accomplished this without owning everyone's favorite stock, Apple, during this period.

The S&P 500 closed the quarter at 1408, which was the best first quarter return for the index since 1998. Every sector in the index except Utilities (the best performer in 2011) saw a positive return with technology and financials leading the way. The stock market's strong performance is pressuring both retail and institutional investors to reconsider their cash and other "risk free" (hardly) assets and to decide whether or not now is the time to enter the market. Bears argue that with productivity rates at all-time highs and earnings growth deceleration in 4Q 11, not to mention a massive deficit hang-over, a slowing China, and struggling European banks, the market is poised for correction. We don't disagree that the road ahead will be bumpy.

However, with low relative P/E's, clean balance sheets, and leaner organizations, stocks continue to demonstrate an ability to prosper in a high unemployment and challenging market environment. Granted, as is well publicized, the markets collectively have had heavy federal government assistance in the form of low interest rates and unprecedented monetary stimulus. Future market performance will in large part be predicated on the market's ability to navigate a post stimulus environment, manage the global sovereign debt crisis, and continue to create meaningful jobs. An uptick in housing wouldn't hurt either. At Alamar, we do not subscribe to short term thinking. In the long run, given the unprecedented levels of cash being held by corporations, and the host of unattractive low interest rate investment options available, we continue to contend that equity markets remain compelling.

To date, the recent run up in the market has had its share of ups and downs and the broader markets remain 10% or so below their October 2007 highs. However, a patient investor who bought the S&P 500 at those '07 highs and re-invested dividends is now very close to that high-water mark. It appears, though, that many market participants have not participated in the recovery.

## FOLLOW THE MONEY

The following chart, provided by the Investment Company Institute, speaks to this point and shows the flow of funds into and out of mutual funds since 2008.

**Figure 1: Mutual Fund Flows**

| YEAR | EQUITY FUNDS ($ Billion) | BOND FUNDS ($ Billion) |
|---|---|---|
| **2008** | $ (228.5) | $ 29.5 |
| **2009** | $ (.1) | $ 380.4 |
| **2010** | $ (36.9) | $ 241.2 |
| **2011** | $ (129.6) | $ 124.2 |
| **YTD 2012*** | $ (28.3) | $ 102.4 |
| **TOTAL:** | $ (417.0) | $ 874.1 |

** Estimates for 1Q 2012,* *Source: ICI*

The data reveals that over the last 4+ years there have been $417 billion in outflows from mutual funds in equities and $874 billion in flows into bond funds. Additionally, at the current Q1 run rate, inflows to bonds for 2012 will be in excess of $300 billion. So, inflows to bonds not only continue, but at an accelerated pace! This despite of the fact that rates are artificially being kept at or near their all-time lows and the bull market for bonds now exceeds 30 years. In fact, even bond manager gurus Bill Gross (PIMCO) and Larry Fink (Blackrock) have recently questioned its longevity.

The next chart looks to identify the extent to which investors have been rewarded in recent years for their risk aversion. It compares the performance of the broader US Equity (S&P 500) and Bond Markets (Barclays Aggregate Bond Index) over the same time period.

**Figure 2: Investment Performance**

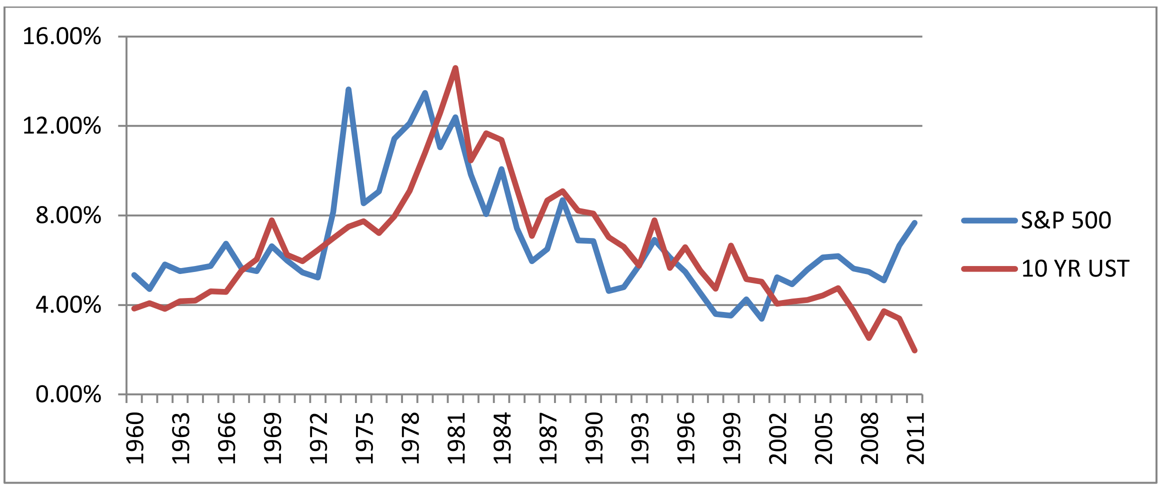
| YEAR | S&P 500 % Return | BARCLAYS AGG % Return |
|---|---|---|
| **2008** | (37.0)% | 5.2% |
| **2009** | 26.5% | 5.9% |
| **2010** | 15.1% | 6.5% |
| **2011** | 2.1% | 7.8% |
| **1Q '12** | 12.6% | 0.3% |

Through 1Q 2012 the annualized return for these strategies since January 2008 is 1.2% for the S&P and 6.0% for the Barclays Aggregate. Clearly, a very savvy bond investor who predicted the '08 crisis has been well served by avoiding the '08 firestorm. However, as the funds data reveals, the much more likely scenario is of an investor who experienced the downturn, reduced exposure to equities, and has been out of the market or overweight to bonds the past few years. Since January

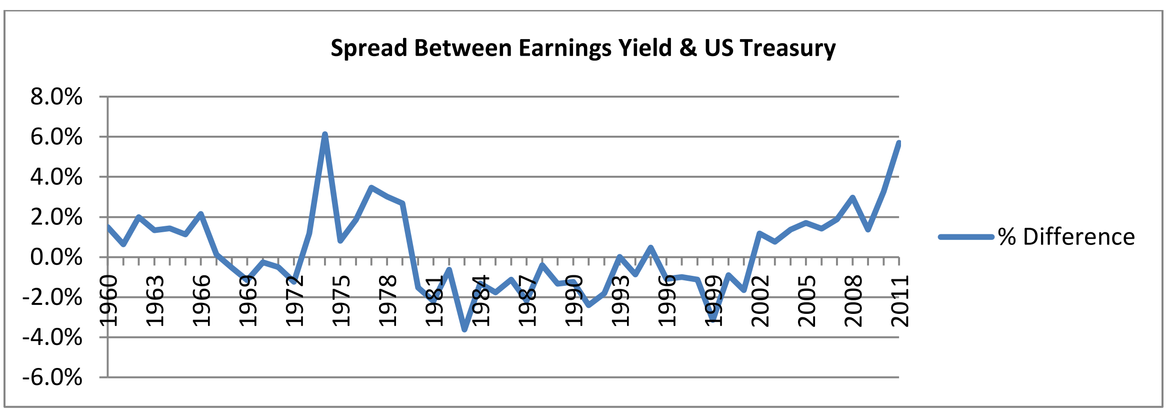
2009 the annualized return of the S&P 500 has been 17.1% while the aggregate bond index has achieved just a 6.3% return. Investors in cash, while preserving their capital, have earned almost nothing on their investment.

Another useful comparative technique involves looking at the earnings yield of a broad equity index against prevailing interest rates to determine whether stocks may be classified as over, or under-valued, compared to treasuries. The earnings yield, or inverse of the P/E ratio, assumes that 100% of earnings are paid out as income, in order to enable an apple to apple comparison to interest bearing investments. Figure 3 below compares the earnings yield of the S&P 500 against US 10 Year Treasuries dating back to 1960. The spread of that difference is calculated in the following chart.

**Figure 3: Historical Yields**




Source: S&P, Aswath Damodaran (NYU), Federal Reserve




Economic theory suggests that investors in equities should demand a risk premium over "risk free" assets to compensate them for the higher risk of owning stocks over bonds. The charts make a fairly compelling case for equities, given the growing disparity of the spread which, as of year-end, rivaled only that of the 1973-74 bear market in the time period. Further, it is debatable whether treasuries truly provide a risk free return in the current environment.

## CONCLUDING THOUGHTS

At Alamar, we are comforted by the companies we own, the management teams that run them, and the bottom up fundamental investment philosophy we utilize. Also, contrary to what you may be hearing in the media, we believe the US economy, warts and all, is on the mend.

Investors need to evaluate whether investing in 10-year treasuries yielding 2%, with no hope for any future growth in income, is a better alternative than investing in stocks with an 8% current earnings yield and potential for future growth in earnings.

We welcome comments and feedback. If you would like to receive future commentary from us or know of others who would appreciate our thoughts please let us know.

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