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Arcataur Capital Management, LLC
826 North Plankinton • Suite 300
Milwaukee, Wisconsin 53203

414 225.8200
FAX 414 225.0043
www.arcataur.com

Even manager is in a holding pattern

Rely on portfolio's diversification and wait a bit before reallocating, adviser says

By KATHLEEN GALLAGHER, kgallagher@journalsentinel.com



In the midst of a deep housing crisis, financial industry meltdown and global market turmoil, some investors have panicked and sold at fire sale prices.

A few others may be buying, hoping they've identified the bottom.

Ignatius L. Smetek is not actively buying or selling.

It's unusual for professional money managers to say they're in a holding pattern, but these are unusual times, said Smetek, president and chief investment

officer at Arcataur Capital Management LLC in Milwaukee.

"I sense from my experience that the dynamics of the markets have gotten to a pretty extreme reading of the situation, so from that standpoint there's probably a lot of opportunity. But a lot of things can happen," said Smetek, a 25-year investment industry veteran.

"It's difficult to be a hero in this market because of the confluence of events."

In recent weeks, despite Congress' passage of the federal rescue plan and other measures, investors' confidence has diminished more. Smetek says his response is to rely on the diversification he built into his portfolios, rather than make dramatic decisions in a very illiquid market.

"It's probably too early to make a major asset allocation switch; however, you have to be looking at your portfolio opportunistically to continue on a diversified path," Smetek said.

He says his big-company stock portfolios have a higher allocation of technology stocks and a lower allocation of energy stocks than the Standard & Poor's 500 index.

Technology names like Apple Inc. (AAPL), Cisco Systems Inc. (CSCO), International Business Machines Corp. (IBM), Microsoft Corp. (MSFT) and Oracle Corp. (ORCL) are well-capitalized, with good balance sheets and low valuations compared with their historical averages, Smetek said. Technology is a good industry to be invested in, and Smetek says he's comfortable continuing to hold these names.

As for opportunities going forward, that will partly depend upon how you think the economy will fare.

Investors who believe a long, drawn-out recession is in the works will want to move to the safest assets. That's why Treasuries and gold have rallied, Smetek said.

He says he isn't among those anticipating a worst-case scenario, though.

We're probably in a recession, but Smetek says he isn't expecting a protracted one. If the financial system problems start improving, the market could hit bottom in the next four months and the economy could bottom out in 12 months, he said.

Most troublesome is the American consumer, who has been the U.S. economy's engine. People in states such as Arizona, California, Florida and Nevada are reeling after going to the "real estate punch bowl" too often, and

troubles are widespread in Michigan and Ohio, with their faltering auto industries.

This is one reason pessimism has taken hold of the stock and bond markets.

"The key question is how much does that pessimism and constriction in credit markets have an impact on the real economy," Smetek said.

He says there's a significant counter to consumers' woes. Corporate balance sheets, excluding financial companies, are in the best shape they've been in 40 years, Smetek said. Cash is 9% of market capitalization, on average, for all the companies except financials in the S&P 500 index.

"The last time we were at 9 percent was in 2002 and 2003," Smetek said.

The federal rescue plan should help restore some confidence, but it will take more than that to get the global financial system working correctly again, Smetek said. Some examples might be more foreign countries adopting bailout plans or further interest rate cuts, he said.

Here are some of the signs he says would get him interested in buying stocks again:

- The yield on the 3-month Treasury bill went to nearly 0% during some of the most stressful days recently, and Smetek says he'd like to see it firmly entrenched above 1%.

- Bank of America Corp., General Electric Co., Goldman Sachs Group Inc. and Morgan Stanley have all issued stock recently. Smetek said he would like to see more signs like that of private capital flowing into the market. He also would like to see more merger and acquisition activity, like Eli Lilly & Co.'s recent announcement it will buy ImClone Systems Inc.

- Anecdotal evidence that banks were doing more lending at reasonable rates to people with good credit.

- A shift in Wall Street's focus to normal signals like corporate earnings and a company's guidance for future earnings, rather than financial system problems.

Until he sees those signs, Smetek said, he's comfortable holding stocks in defensive industries such as consumer staples and health care. Some stocks he said he owns include Abbott Laboratories (ABT), Johnson & Johnson (JNJ) and PepsiCo Inc. (PEP).

When those signs start appearing, he'll start looking at opportunities in sectors such as consumer cyclicals, energy and financials, he said. Some names in those areas that he already owns and would consider adding to are EOG Resources Inc. (EOG), Goldman Sachs (GS), JP Morgan Chase & Co. (JPM) and Wells Fargo & Co. (WFC).

What about cash, though?

Smetek says most of his clients have some high-quality bonds. But in a diversified portfolio, dividends and interest income accumulate.

Smetek said he's been keeping that cash fairly liquid by using three-month certificates of deposit to maximize safety.

The federal rescue plan includes a higher \$250,000 maximum of bank account assets that are eligible for federal deposit insurance, compared with the previous \$100,000 limit. In some cases, investors can get more than \$250,000 insured by titling their accounts differently, Smetek said.

For more information about the rules for that, visit www.fdic.gov.

This column examines one stock through the eyes of a professional investor to show how market pros make investment decisions. Neither Kathleen Gallagher nor the Journal Sentinel recommends specific investments or endorses the recommendations of those interviewed.

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