

4Q09 LifeStylesSM Commentary

The economic recovery continued to gain a foothold in the fourth quarter and the financial markets resumed their climb higher in what has been a remarkable reversal from the extreme pessimism surrounding risk-assets the same time a year ago. Performance was positive across most major asset classes in 2009, but the biggest gains came from the most economically sensitive areas (i.e. technology, consumer discretionary and materials stocks) and the biggest beneficiaries of the reopening of the credit markets (high-yield corporate bonds, REITs). The recurring theme across the investment landscape was that of a renewed appetite for risk as the worst performers in the 2008 bear market were generally the best performers in 2009. All LifeStylesSM portfolios outperformed their benchmarks during the quarter and for the full year by a significant margin. Positive contributors to performance came from both our tactical asset allocation decisions as well as strong performance of the underlying managers relative to their benchmarks and peers.

In the most conservative portfolios, the bulk of the outperformance was the result of favorable positioning within the fixed income space. An underweight to U.S. Treasury bonds in favor of corporate credit and other "spread" sectors continued to benefit the portfolios as government bond interest rates rose (causing downward pressure on prices) and the credit markets resumed functioning, thus reducing the amount of liquidity risk in the system. Throughout the year, investors have steadily ventured out of their ultra-safe, but low-yielding investments toward higher-risk, higher-return vehicles such as investment-grade corporate bonds, high-yield bonds and bank loans. An overweight exposure to TIPS (Treasury Inflation-Protected Securities) also contributed to the portfolios' outperformance vs. the benchmarks last year. TIPS, which act as a hedge against inflation, typically perform well when inflation expectations rise. On the heels of an improving economy, a massive stimulus package (the bulk of which is yet to be spent) and the Fed's extremely accommodative "low for long" monetary policy, investors began to shift their focus from a fear of deflation to expectations of higher inflation down the road.

Going into 2010, we remain conservative on our yield-curve positioning based on our concern over the looming end to the "quantitative easing" policies of several of the world's central banks, as well as the coming wave of new debt set to be issued by governments of developed nations in order to finance their sizable budget deficits. If this new supply is not met by sufficient demand from investors and the economy continues to improve, the result will be higher rates from their still historically low levels. We favor short-term bonds over long-term bonds and investment-grade corporates over nominal Treasuries as we seek to avoid the areas that are most sensitive to increases in long-term interest rates. Also, given the dramatic 52% run-up in senior-secured floating rate bank loans last year (following their negative 29% sell-off in 2008) we have become more cautious in this asset-class. The bank loan sector has seen unprecedented volatility over the past two years as dislocations in the market caused prices to veer far from fundamentals during the panic of 2008. While we anticipated a recovery in 2009 from extremely oversold conditions, the speed and magnitude of the rally was surprising and we now believe the loans are priced close to what the fundamentals suggest. In the first quarter of 2010, we are significantly trimming our exposure to the Eaton Vance Floating Rate Fund across the portfolios, allocating the money to the short-term bond category. This should result in lower volatility for the more conservative portfolios going forward.

In the equity-leaning portfolios, the outperformance for the year came mainly from our over-weight to growth over value, an overweight to international equities, a tactical carve-out to emerging markets and overall strong performance of the underlying managers relative to their peer groups and benchmarks. Growth strategies have a significantly higher weighting in technology stocks relative to value strategies, which proved to be a big advantage in 2009 as technology was by far the best performing sector of the market. International developed markets had a strong year relative to U.S. domestic equities, mostly as a result of the falling dollar. Emerging markets equities led all market segments as they skyrocketed almost 75%, rebounding from their precipitous 54% drop in 2008. Investors awarded a premium to these developing countries' ability to continue to post strong growth while the developed world struggled to emerge from recession. Finally, many of our managers (especially in the large-cap value and large-cap blend categories) had exceptional years last year with a few bouncing back vigorously from disappointing showings in 2008.

Despite the strong performance from our equity sleeve, we were not immune to mistakes last year as evidenced by our bias toward large-cap stocks over mid-cap and small-cap names. We had the portfolios positioned toward large caps early in the year because of our belief that the U.S. economy had a considerable amount of headwinds facing it (high debt burdens,

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high unemployment, frozen credit markets, deteriorating credit, etc.) and thought large caps would be better positioned than small caps due to their more diversified nature and more favorable access to capital via debt and equity issuance. As it turned out, however, mid and small caps experienced the biggest bounce off the March 9th lows and built a sizable lead over large caps during the second and third quarters as the credit markets healed and the more speculative names led the market. In the fourth quarter, large caps began to outperform as the rally moderated, but not enough to make up for the prior two quarters. Going forward, we are maintaining our large-cap and growth overweights as we feel higher quality companies with sustainable earnings growth prospects will be rewarded in a below-normal growth type of environment.

While 2009 was a very good year for the *LifeStyles*SM portfolios, we are far from content. We remain diligently focused on the road ahead and stand ready to make the necessary adjustments in order to navigate the ever-changing investment landscape. Our time-tested, disciplined investment process continues to be our most valuable tool and the backbone of our commitment to superior long-term performance for our clients.

The commentary was written by Reliance's Nicholas Cotter, CFA, Investment Analyst. Questions or comments about *LifeStyles*SM portfolios or other investment services offered by Reliance, contact ncotter@relico.com.