

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Large-Cap & Fixed Income GARP Investing



ROBERT M. LEGGETT, CFA joined FirstMerit as Chief Investment Officer for FirstMerit Wealth Management Services in May of 2005. He is a Senior Vice President and is responsible for the strategic planning and investment results of FirstMerit's \$2.5 billion in client investments. He leads FirstMerit's veteran investment management team of more than a dozen professionals. He has more than 25 years of experience leading investment management teams. Prior to joining FirstMerit, he was the CIO of Gries Financial, LLC (an investment management and financial planning boutique in Cleveland), and President and Managing Director of the National City Investment Management Company. He began his career in Columbus, where he was the Director of Investments for the Ohio Bureau of Workers' Compensation, after spending over 15 years in various

roles at the State Teachers Retirement System of Ohio. He is a Chartered Financial Analyst (CFA) and a Certified Wealth Advisor (CWA). He holds a bachelor's degree from The Ohio State University.

SECTOR – GENERAL INVESTING

TWST: Why don't you start with an overview of what you do at FirstMerit and your investment philosophy?

Mr. Leggett: As Chief Investment Officer at FirstMerit, I've been actively engaged in working with our various teams in morphing what has been a very good and very solid bank trust department into a broader, more integrated wealth management services organization. Although we've been doing investment management for high net worth individuals and institutions for decades (with roughly \$2.3 billion of assets under discretionary management), we upgraded the investment staff over the last four years and also increased the range of investment solutions offered. Not only do we offer stocks, bonds, and mutual funds, but also exchange-traded funds (ETFs), separately managed accounts and brokered CDs.

Our investment philosophy is "Active Advice", which means we proactively manage client accounts to capture opportunities, mitigate risk and thus achieve client objectives. We believe this approach goes a long way in addressing the difficult question facing investors: "How can I earn the best returns without taking undue risk of loss?"

TWST: How does that translate into how you work with your clients?

Mr. Leggett: We have a very strong focus on understanding what our clients' needs are, so we begin by working with them on their investment policy statement and then operate within that statement in

terms of asset allocation. To implement the policy, we create investment plans that utilize the appropriate mix of assets and styles.

We know that asset allocation decisions are going to drive investment results. That is why we spend a lot of effort up front to figure out the best plan for each of our clients. In terms of our client relationship philosophy, it's really to deliver that active advice to our clients.

We consistently preach the advantages of diversification to our clients. For decades, we have used a broad range of stock/bond allocations in our clients' accounts. As recently as twenty years ago, this was really the only decision to make. Now of course, we have multitudes of "styles" available, plus the so-called alternative approaches such as hedge funds and private equity funds. This has had a significant impact on FirstMerit client portfolios. Several years ago, we implemented a series of diversified portfolios using mutual funds which invest in US stocks ranging from large to small and growth to value, as well as developed and emerging economy international stocks and a range of fixed income styles. In 2006, we expanded our offerings to include FirstMerit Select Portfolios (selected external style specific managers). Last year we introduced etfFIRST which utilizes exchange traded funds to create six asset allocation models that offer different risk/reward characteristics.

TWST: Let's focus on the asset allocation first because that must be the most important step in customizing your portfolios.

Mr. Leggett: We are big believers in strategic asset allocation.

After we go through the questionnaire process with a new client and determine their financial situation, what their goals are, and what they expect from us as their investment manager, we can set their target asset allocation. We then discuss the current environment with respect to the economy and financial markets and what our outlook is into the future. This is harder than it sounds to do well. Over the past few years it has often been very difficult to fully understand the current situation, much less to predict the future! Nonetheless, given that the financial markets do indeed discount the future, we have little choice but to attempt to do so.

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As anyone on my team would tell you, one of my favorite statements is: you cannot succeed in investment management without building and implementing logical investment processes ... and if you cannot write your process down – you don’t have one!

So, we spend a lot of time strengthening our investment disciplines by regularly revisiting them to see where they can be tweaked and improved. With regard to strategic asset allocation, the key to our process is the monthly review of the FirstMerit Market Meter. The reading of this proprietary model impacts both asset allocation decisions and how bullishly or defensively we structure our equity and fixed income portfolios.

Another one of our disciplines is to create checklists that are aimed at giving us timely alerts when economic trends are changing. Most recently during the recession, we developed an Expansion Signals Checklist. It consists of ten indicators that typically change direction close to the end of recessions or early in new economic expansions. If it turns out to be a false start (as many people think currently) the signals don’t switch on. I can tell you our list right now is clearly telling us that the probability is high that we’re entering a period of economic expansion. That’s an important factor to us in our Moderate Growth strategy because as we went into 2008 and through 2008, our macro work was telling us that a recession was very likely. It caused us to end up raising a fairly significant cash reserve to protect our portfolios in a bear market that we expected to be a nasty bear market and which became one of the worst bear markets that any of us have seen. We are closer to the opposite end of that spectrum now and so we have moved to a much more bullish stance.

TWST: Sounds like an important part of the process. Tell me more about the Market Meter.

Mr. Leggett: The Market Meter has four inputs: Major Trend, Fundamentals, Federal Reserve and Technical. We’ve successfully used the Market Meter for over 25 years to drive asset allocation strategy for both individual and institutional investors.

Our first input is the trend of stock prices over the very long term. This input is designed to keep us from losing sight of the strategic importance of the very long-term upward bias to stock prices. It is a fact

that stock prices increase over time as the economy, corporate profits and dividends grow. For the Major Trend we analyze both nominal prices (a new high in 2007, so a plus) and constant dollar or inflation-adjusted trends (no new high in 2007 and a new low 2008, so a minus) from peak to peak and trough to trough. They currently net to 0.

Market Meter input number two, has two components: our reading of the and Market Valuation. The direction and strength of the economy, inflation, interest rates and earnings are the primary Fundamental drivers for the stock market. We primarily focus on current trends rather than basing our strategy on trying to predict reversals. We recently upgraded the Economy from -1 to 0 and expect the data to push it to +1 soon. For the Stock Market Valuation input, we compare the market’s price/earnings ratio and dividend yield to historic ranges and to bond yields. We also pay attention to estimate revisions which are just beginning to turn positive. Valuations are just at fair levels, so stronger positive revisions are needed to bump this input up from its current 0 rating.

What else do you need to know to make informed investment decisions? We believe in the market adages “Don’t Fight the Fed” and “Don’t Fight the Tape”, so we have inputs that represent our opinion for each of them.

For Market Meter input number three, we ask whether the Reserve is on the sidelines or actively working to take away the punchbowl. We are wary of underestimating the power of the Fed, so we give it an important weighting in the Market Meter. Given the high octane punchbowl-spiking underway, we rate the Fed +1.

The final input to the Market Meter is our analysis of Technical data (the Tape) including price patterns, supply/demand, sentiment,

Highlights

Robert M. Leggett says that his investment philosophy is “Active Advice,” which means that he proactively manages client accounts to capture opportunities, mitigate risk and thus achieve client objectives. He is using ETFs representing smaller US, international developed, international emerging markets, US and international real estate, and natural resources. He believes this is a good first step toward expanding into other alternative areas such as long/short funds or private equity. He deploys three equity strategies: GARP, Core & Explore, and Opportunistic. On the fixed income side, the bulk of assets are in laddered-maturity high quality bond portfolios. The keys to his firm’s success is that the team is fanatical about adhering to the firm’s proven processes and disciplines, and the strategic asset allocation approach has been refined further by the implementation of tactical asset allocation. Companies include: Goldman Sachs (GS); Prudential Financial (PRU); Home Depot (HD).

breadth and momentum. The important point with regard to Technical analysis is that many, many, many investors rely on it. That means it cannot be ignored, even if one thinks it is voodoo. There are two parts to Technical. For our longer term Trend Analysis, we review weekly and monthly patterns and momentum. The weekly picture is now positive but monthly improvement is not yet sufficient to move our Trend rating

age of assets diversified beyond U.S. large cap stocks. We determined that we could add value by using exchange traded funds. We determined that we would invest 20% to 40% of our equity allocation in these exchange traded funds representing smaller US, international developed, international emerging markets, US and international real estate, and natural resource ETFs. We believe this is a good first step toward expanding into

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above 0. Our Short Term Technical input reflects our belief that the stock market is driven by sentiment, supply/demand and momentum in the shorter term. The score from this input is often volatile, but it is currently a solid +1.

If you've totaled up the points as I went over the Market Meter, you can see it is now at +2 versus a potential range from -6 to +6. As with physical meters or gauges, both the level and trend of the Meter reading is critical. Our growing bullishness has been driven by the Market Meter improvement from -3 in March which we expect to continue to +3 or +4 in coming months.

TWST: And how is the Market Meter utilized for investment strategy decisions?

Mr. Leggett: Let's say that we ended up with a target-invested position for a client of 70% in equities and 30% in fixed income. Our normal strategic asset allocation band around that would be plus or minus 10 percentage points in the asset classes. Over the past year, we've seen a market environment unlike anything we've experienced in our careers. That caused a lot of our clients to rethink what their risk tolerance should be. It's really caused us, as advisors, to think about our in-

other alternative areas such as long/short funds or private equity.

TWST: Can we move on then to your equity investment strategies, which you described as moderate growth?

Mr. Leggett: Our philosophy is Growth at the Right Price or GARP. Our core FirstMerit Moderate Growth equity approach is inherently diversified as its GARP disciplines include aspects of both growth and value. We have also successfully used mutual funds and exchange traded funds (ETFs) to gain access to international markets and smaller stocks. Typically we have held about 15% of equities in styles other than large domestic stocks. Again last year we arrived at the conclusion that broader diversification would serve our clients well by enhancing expected returns and reducing overall portfolio volatility.

We call this a "Core & Explore" approach. The Core continues to be our diversified large US stocks portfolio, while the Explore is a group of ETFs which add diversification as discussed earlier. Adding these ETFs should reduce volatility over time because the indexes they represent are less correlated to large US stocks than our Moderate Growth approach. It also gives clients a mixture of active and indexed holdings.

We are not optimists on the longer-term economic outlook. The de-leveraging impact of the bursting of the credit bubble on consumers, businesses and certainly on the financial sector, is going to have long-lasting results. The demise of the shadow banking system, the downsizing of Fannie and Freddie and tightened bank lending standards mean that it's going to be very difficult to get anything close to the credit generation that we've seen over the last 15+ years.

vestment philosophy for our clients and perhaps focus more than we had in the past on thinking about absolute returns and on account drawdowns during adverse market conditions.

In doing that work one of our current high priorities is to determine the best ways to deliver alternative asset class exposure. I'm referring to the classes that are not well correlated with either the US equities market or the bond market. Prior to the second quarter of 2008, we had up to 15% of a client's equity portfolio in either international mutual funds or small cap or mid cap domestic stock mutual funds.

We decided in early 2008 that we needed to get a higher percent-

Getting back to GARP, one of the great things about it is if you understand where you are in the economic and market cycles you can focus your stock selection by either capitalizing the "G" or the "RP", or you can balance growth and value by viewing all of the letters equally. Our belief as GARP managers is that superior earnings growth bought at a reasonable valuation will allow you to outperform the stock market over time. What we've developed here for stock selection is a combination of internal research and Wall Street research. Street research is a fairly significant part of the process, but we are not relying on the Street for buy and sell recommendations. We use their basic fundamental work

on companies and on industry sectors and then run companies through our company review process to determine which stocks we will include in client portfolios.

We screen the databases we use for various fundamental and valuation characteristics. As part of our process, we have a list of characteristics that allow us to divide the stocks into three categories. The first group is Core stocks, which are exactly what you would expect: stocks with a compelling long-term investment premise including high confidence in their earnings growth prospects. For a Core stock, we will

impact of the bursting of the credit bubble on consumers, businesses and certainly on the financial sector, is going to have long-lasting results. The demise of the shadow banking system, the downsizing of Fannie and Freddie and tightened bank lending standards mean that it's going to be very difficult to get anything close to the credit generation that we've seen over the last 15+ years. We think that nominal GDP growth will therefore be slower. I would say we are with the consensus from that perspective. We've differentiated ourselves in our perspective thus far in 2009 is that in April, we started shifting to thinking the economy would be improving.

"Even if this turns out to be a 'W' shaped economic recovery, to get to a 'W', you first have to have a 'V', and we think that people continue to underestimate the amount of pent-up demand that's out there...Now we've seen second quarter GDP and right now the government is saying it was only minus 1%. Who knows where it'll end up after the revisions, but it's clearly a lot better than minus 5% or 6%. We think we are going to see positive GDP for the next two to four quarters."

be able to calculate High Valuation price targets that suggest significant upside in the stock either through earnings growth or improved valuation. A history of positive earnings estimate revisions is another plus factor. The most defensive category of stocks are called Income stocks which have dividend yields above the S&P 500. For these, we want to see a history of dividend increases, well covered payouts and above average financial strength.

We were definitely leaning toward Core and Income stocks last year which helped us to outperform our benchmarks. Our high quality perspective kept us from falling into the trap of buying a lot of financial sector stocks that had high yields. We have had a very significant underweight in the financial stocks for nearly two years, which ties into our third category of stocks which we call Opportunistic. With Opportunistic stocks, our analyst must list the catalysts for outperformance over the next 6 - 12 months. We definitely look for earnings that will be better

1-Year Daily Chart of Goldman Sachs Group



Chart provided by www.BigCharts.com

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than expected and we would much prefer to see positive surprises in place. That's one of the things we've been using as we've grown more optimistic about the economy this year. Our goal was to find some financial stocks that would meet our opportunistic characteristics and allow us to get our weighting in financial stocks back up again.

TWST: Are you seeing opportunities in the current market? Is this a good time for opportunistic investing?

Mr. Leggett: Yes, we think so. I write a quarterly market message that we send out to our clients. The headline of the early July issue was "The Recession is Ending." It's important to note, however, that we are not optimists on the longer-term economic outlook. The de-leveraging

Even if this turns out to be a 'W' shaped economic recovery, to get to a 'W', you first have to have a 'V', and we think that people continue to underestimate the amount of pent-up demand that's out there. The economy literally hit the wall going into the fourth quarter of last year, and it worsened at a rapid pace through the first quarter of this year. Now we've seen second quarter GDP and right now the government is saying it was only minus 1%. Who knows where it'll end up after the revisions, but it's clearly a lot better than minus 5% or 6%. We think we are going to see positive GDP for the next two to four quarters.

One major result of the economy basically coming to a standstill for six months is the truly astounding amount of costs that have been

shed by corporations. They cut capital spending and slashed inventories and employment as they focused on corporate survival. When they realize that orders are getting better, they will have to pick up output and as output picks up, there is a reasonably good chance that employment (despite permanent job losses) can be better than people expect. This brings me back to your original question about Opportunistic stocks.

We do think that there are many stocks that represent companies that are going to do well in a period of better-than-expected economic growth.

"We do think that there are many stocks that represent companies that are going to do well in a period of better-than-expected economic growth. We expect profit margins will bounce back fairly quickly because, at a minimum, we should experience better economic data well into 2010. If we get really lucky, it will become a sustainable recovery."

1-Year Daily Chart of Prudential Financial



Chart provided by www.BigCharts.com

number-one or number-two position in numerous business lines, no other company is better positioned to benefit from the macro trends in an improving near-term market environment. When purchased **GS** had a 9x p/e on 2010 estimates that we believe will experience significant further upward revisions.

With regard to Prudential, we anticipate positive surprises in their asset management and investment businesses. Also, their international operations should continue to support growth prospects. Initially,

we held off adding the stock based on concerns over capital adequacy and exposure in commercial mortgages. However, these concerns dissipated after Prudential successfully raised capital, avoided TARP, and maintained a lower-risk profile in the commercial mortgage market due to its underwriting discipline. PRU was selling at about 7x 2010 estimates and we expect longer term eps growth to exceed 10%.

We held a notable underweight to the consumer discretionary sector during the recession. As our economic outlook has improved, we have changed the portfolio. An increase in the relative weighting in discretionary stocks is consistent with this phase of recovery as the stock market anticipates economic expansion. One consumer stock we added is **Home Depot (HD)**. Decreasing headwinds from the economy, improved merchandising, and operational improvement in the distribution network will aid in near-term outperformance and supportive long-term potential. We chose **HD** over **Lowe's (LOW)** as the story more likely to improve. **HD** is shifting focus toward a better retail store experience for customers.

"Initially, we held off adding Prudential based on concerns over capital adequacy and exposure in commercial mortgages. However, these concerns dissipated after Prudential successfully raised capital, avoided TARP, and maintained a lower-risk profile in the commercial mortgage market due to its underwriting discipline."

growth. We expect profit margins will bounce back fairly quickly because, at a minimum, we should experience better economic data well into 2010. If we get really lucky, it will become a sustainable recovery. Either way for our investment time horizon for Opportunistic stocks, which is two to four quarters, we think that there are a lot of stocks out there that can do very well.

TWST: What would be examples of stocks you've purchased this year?

Mr. Leggett: Two examples of financials we added this year are **Goldman Sachs (GS)** and **Prudential Financial (PRU)**. We expect **Goldman Sachs** to continue to gain market share and improve margins in almost every facet of the Company's business. Based on the **Goldman's**

As they become more like **LOW** in this regard, **HD** has much more room for increases in earnings estimates than **LOW**. **LOW** may today be the better company, but **HD** is more likely to be the better stock as the recovery unfolds.

TWST: What about your fixed income strategies? How's that been over the last 12 months, and what is the outlook going forward?

Mr. Leggett: On the fixed income side, the bulk of our assets are in laddered-maturity high quality bond portfolios. Our focus in fixed income is to get the best income we can for our clients without sacrificing quality at all. We stick to investment grade and typically toward the upper end of investment grade, both in corporates and in municipal bonds. Be-

tween US Treasuries and US Agencies, we have a bias toward Agencies. Our reasoning is that regardless of what the government has said, we believe that the full faith and credit of the US government backs them. Also, clients earn a bit higher return from Agencies versus Treasuries.

We do have institutional accounts that we manage on a total return fixed income basis where we are managing against the benchmark, either the Barclays Intermediate or the Barclays Aggregate. In our

Mr. Leggett: We only use high-yield bonds if the situation is appropriate for the client and they understand the risk, and we only do that through mutual funds or ETFs. If a client wants an exposure to high yield, for one thing, we don't want to be trying to do that level of credit research internally. The second point is that the key to a high-yield bond portfolio's success is having really significant diversification, and to achieve that, we feel it's much better to use funds.

"We chose HD over Lowe's as the story more likely to improve. HD is shifting focus toward a better retail store experience for customers. As they become more like LOW in this regard, HD has much more room for increases in earnings estimates than LOW. LOW may today be the better company, but HD is more likely to be the better stock as the recovery unfolds."

1-Year Daily Chart of Home Depot



Chart provided by www.BigCharts.com

TWST: What do you think gives your investment approach to equities and fixed income in general its edge? What do you feel that you bring to the table at FirstMerit that other companies might not?

Mr. Leggett: Two keys are 1) we are fanatical about adhering to our proven processes and disciplines. You would think everybody would do that, but obviously they don't. 2) We have refined our strategic asset allocation approach further and have now implemented tactical asset allocation or TAA.

Our research suggests that even if March 2009 represents the nominal Bear Market low, constant dollar equity returns from here may continue to track well below historic norms. That is reflected in the neutral reading of our Market Meter's Major Trend input. Growth of buy-and-hold portfolios are likely to trail the growth of accounts that successfully implement tactical asset allocation shifts.

As we have often stated, we believe the impact of the forced

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fixed income total return portfolios we apply our disciplined process to determine relative portfolio duration, or to increase exposure to the sectors that we believe will outperform the other parts of the benchmark. We've had very good results on the fixed income side from those institutional accounts and we've had no blowups in our laddered high quality accounts. In 2007, when we grew nervous about the financial stocks, we also took a good hard look at the financial sector corporate bonds and cut back our exposure to anything that we feared might suffer in a recession. We stopped buying financial sector corporates, which certainly served us well during past year and a half.

TWST: Do you ever use high-yield bonds, more risky bond structures?

deleveraging of consumers, investors and the financial system will be a drag on global economic growth for years to come. The second long-term worry is the risk that fiscal and monetary stimulus won't be withdrawn on a timely basis. The risk in that is that you could end up with the resurgence of inflation and in a worst-case scenario, debasing the currency. We are not predicting that, but we think those concerns will put a cap on equity market returns. We could end up in a situation very similar to the 1966-1982 period when the DJIA went from 1000 in 1966 to 1000 in 1982. Real returns after inflation reflected a very significant loss of purchasing power for buy-and-hold investors.

Now within that period there were a lot of cyclical swings and there were definitely periods where different types of companies or sec-

tors of the economy performed very well and there was significant money to be made. Our concern is that the peaks in the S&P and in the Dow that were achieved in October 2007 could turn out to be high watermarks that hold for a long time. This perspective that stocks will go up and down, but will not reward you for putting in place a static portfolio for possibly the next three to five years indicates to us that you will need to make significant asset allocation shifts within portfolios.

We have created a structure and plan for implementing Tactical Asset Allocation in client accounts. The basic plan is very straightforward – sell into strength and buy after weakness. It's a basic "Sell Higher, Buy Lower" plan. The goal is to be at or above longer term strategic asset allocation targets for stocks during cyclical Bull Markets and well below those targets in Bear Markets. That may sound like Market Timing but we differentiate them as follows: Market Timing is a speculator's tool that requires quick moves in/out of asset classes creating high turnover which increases risk and causes short term (i.e. fully taxed) gains if it's successful. Tactical Asset Allocation is very different. It is an investor's tool which uses planned adds or trims of a portion of portfolios. Under our plan, TAA is a lower turnover discipline which aims at decreasing risk and pays attention to tax management.

TWST: How is this Tactical Asset Allocation plan working?

Mr. Leggett: Our TAA plan causes us to constantly look out over the next six months to see if current trends are likely to continue. In November of 2008, the market started to rally, but we didn't see signs of a cyclical bull market developing. We set S&P 500 price levels that, if reached, would force us to further increase cash reserves. The first level was hit that month and the next level was hit right at the start of 2009 so we sold a set portion of our equities each time. Then as our Market Meter

readings improved this spring and into the summer, we shifted to the other side of Tactical Asset Allocation which calls for adding to equities as the Meter improves or buying after stocks correct.

If you looked at the equity allocation of an average Moderate Growth account at the end of February, it would have held about 53% in Core stocks, 23% in the Explore exchange traded funds and about 24% in cash. Due to our TAA plan, those numbers are now 69% in stocks, 29% in ETFs, and about 2% in cash. To get to there, we added more dollars to the Explore ETFs, but primarily it was finding stocks that met our opportunistic characteristics and watching their prices increase.

Bottom line, we think that the key differentiator that we offer to our clients is something that not many investment advisors do, and that is to have this very disciplined approach. We try to keep it simple and to sell high and buy low, staying invested in equities during cyclical advances and then protecting account values by trimming the portfolio back when we see danger signs.

TWST: Thank you. (PS)

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