

2012

Mid-Year Update

Despite ongoing and unprecedented stimulus measures, the global economic recovery appears quite fragile and some areas may already be back in recession. The core problem of too much debt in the developed world remains and will continue to provide headwinds to global growth as we continue to work our way through a multi-year deleveraging process.

While the U.S. faces serious problems of our own, it remains relatively unscathed, so far. However, problems in Europe appear to have gotten worse, as many of the so-called solutions and bailouts have proven to be ineffective political half-measures. Spain now appears to be inching closer to a crisis requiring another bailout and the economic conditions in Greece, ground zero for the European unwinding, appear to be approaching a full-blown depression with limited growth prospects. The prescription of dramatic austerity has only made conditions worse in the short-run, creating dissent among various electorates.

Aggressive central bank stimulus policies have done little to foster economic growth, but they have had distorting consequences in the capital markets. With interest rates near zero, investors have been compelled to flee money market funds in search of higher returns. Many of these outflows have found their way into bond funds, creating very low yields in “safe haven” assets. On the other hand, equity markets, while likely not at the beginning of a secular bull market, appear reasonably priced, particularly in comparison to many other assets around the world. While growth estimates have slowed recently, corporate earnings are one of the few bright spots in global capital markets.

Mid-Year Capital Markets Review

Global equity markets declined nearly 6% during the second quarter, reducing year-to-date returns to just under 6%. Most of the decline during the quarter occurred in May, as the European crisis once again scared investors into retreat. The U.S., despite its debt and deficit levels and slowing economy, continues to be viewed relatively favorably with markets declining a more modest 3% during the quarter, bringing year-to-date performance to 9%. This is a remarkably strong result given all of the uncertainty in the world today and is due primarily to the continuing strong performance of corporate fundamentals, which remain one of the bright spots in the global economy. Despite record low yields, Treasury Bonds posted positive returns, reducing yields even further.

Taking a longer view, equity returns continue to disappoint investors. Over the last five years, global equity markets have declined nearly 3% per year. Over this same period, the average hedge

fund has similarly disappointed investors, returning 1%. Only fixed income and gold have generated strong results.

It is also worth noting that the areas of strong performance over the last few years have been relatively narrow. For example, the top 50 U.S. stocks have outperformed the smallest 2,000 stocks by nearly three percentage points since the beginning of the year. With a relatively small number of winning stocks, it is no surprise that many active management strategies have struggled, continuing the trend of the last few years. Over 80% of large cap equity mutual funds underperformed the S&P 500 in 2011 and this trend is continuing to a similar degree through June of 2012. Likewise, hedge funds have struggled to generate performance through security selection, as both their long and short positions have tended to move in lock-step with the market. For the year, the average hedge fund returned less than 2%.

Table 1: Capital Market Performance

Market	Index	QTD	YTD	3 Year	5 Year
Global Equity	<i>MSCI AC World</i>	-5.6%	5.7%	10.8%	-2.7%
U.S. Equity	<i>Russell 3000</i>	-3.1%	9.3%	16.7%	0.4%
International Equity	<i>MSCI AC World ex U.S.</i>	-7.6%	2.8%	7.0%	-4.6%
Emerging Market Equity	<i>MSCI Emerging Markets</i>	-8.9%	3.9%	9.8%	-0.1%
Hedge Funds	<i>HFRI Fund Weighted</i>	-2.7%	1.9%	5.2%	1.1%
Conservative Hedge Funds	<i>HFRI FOF Conservative</i>	-1.4%	1.0%	2.4%	-1.9%
Municipal Bonds	<i>Barclays Mgd Money Short/Int</i>	1.3%	1.3%	5.6%	6.0%
Commodities	<i>Dow Jones UBS Commodity</i>	-4.5%	-3.7%	3.5%	-3.7%
Gold	<i>Spot Price of Gold</i>	-4.3%	2.1%	18.2%	18.7%

Global Economic Environment

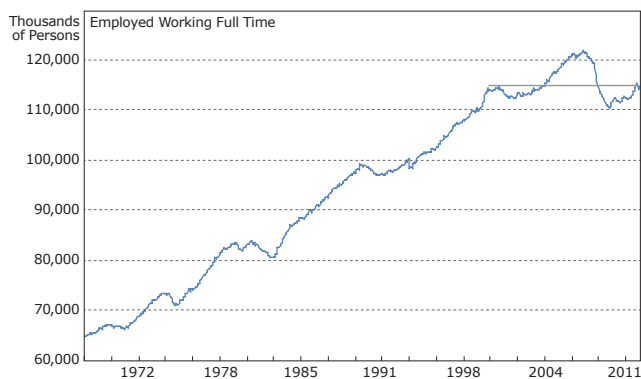
We titled our Annual Outlook “Same Train, Next Station” to reflect our view that the structural problems plaguing the global economy remain unresolved despite the extraordinary monetary and fiscal stimulus efforts implemented by governments and central banks around the world. Unfortunately, not much has changed. Recent economic statistics suggest that the global recovery is extremely fragile and some areas may already be heading back into recession, further compounding the difficult task of finding lasting solutions.

The U.S. Remains the Best of a Bad Bunch

The U.S. remains the best of a bad bunch and several developments provide additional cause for optimism. We are in the early stages of an energy revolution that appears likely to sharply reduce living and manufacturing costs in the coming years. Much of our banking system is on the way to recovery and appears relatively well capitalized (at least in comparison to their European brethren). The technology sector in the U.S. continues its vibrancy and the housing market appears to be bottoming in certain areas.

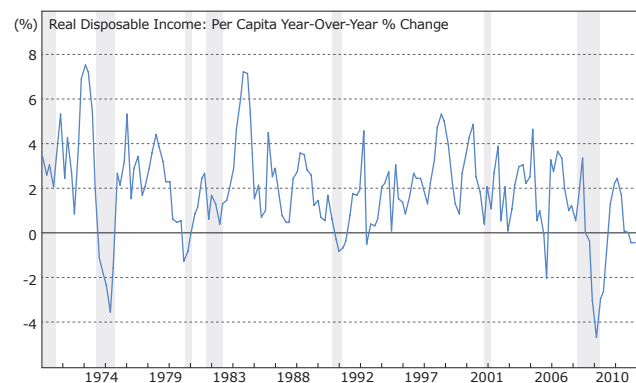
However, these optimistic signs for future U.S. growth must be put into a broader context. Chart 1 shows that full-time employment remains mired at 1999 levels while the work force has grown by over 30 million people. Official unemployment statistics, which appear to be improving modestly, have deleted many of these people from the workforce as they are “discouraged” and no longer seeking employment. As a result, growth in real disposable personal income has fallen back into negative territory, which is typically consistent with recessionary periods as shown in Chart 2. Worse yet, transfer payments as a percentage of disposable income (essentially government handouts) are still 25% above pre-recession levels, implying that personal income has room to fall further when these programs end. Further, while we don’t believe government leaders will let the U.S. economy fall off the proverbial “fiscal cliff” at year-end when the Bush tax cuts and other programs are set to expire, it’s likely that political pressure to reduce the budget deficit will require some concessions, putting additional pressure on economic growth.

Chart 1: Full Time Employment Has Only Recovered to 1999 Levels



Source: US Department of Labor, Bureau of Labor Statistics, St. Louis Federal Reserve

Chart 2: Personal Income at Recession Levels



Source: St. Louis Federal Reserve

Nothing Is Being Solved In Europe

Europe is essentially in the same place it was at the beginning of the crisis, but with more debt and worse economic conditions. In March of this year, European leaders hailed the resolution of the Greek debt crisis as the largest sovereign debt restructuring in history. One analyst recently pointed out that “Greece is back up to almost €400 billion in debt (more than it had pre-bailout), and its sovereign bond yields are back above 29%. It’s as if the March bailout never happened.” At the very least, it’s a good bet that a new sovereign restructuring record will be set in the near future.

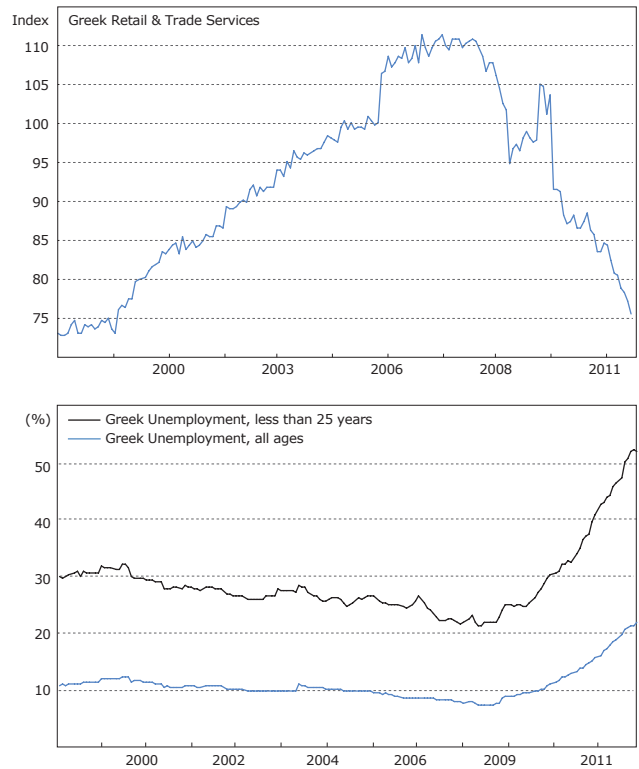
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How did we get back to this point so quickly? Much of Europe had a taste of austerity and decided they didn’t like it. To be honest, it’s difficult to blame them. Chart 3 shows that Greek retail sales have plunged to levels not seen in over a decade. Unemployment is accelerating toward 25% and has now surpassed 50% for people under 25 years old. Spain and other countries have similar problems. It’s difficult to sell this to your electorate as a good solution, and it is likely that real reform and lasting solutions will not arrive quickly.

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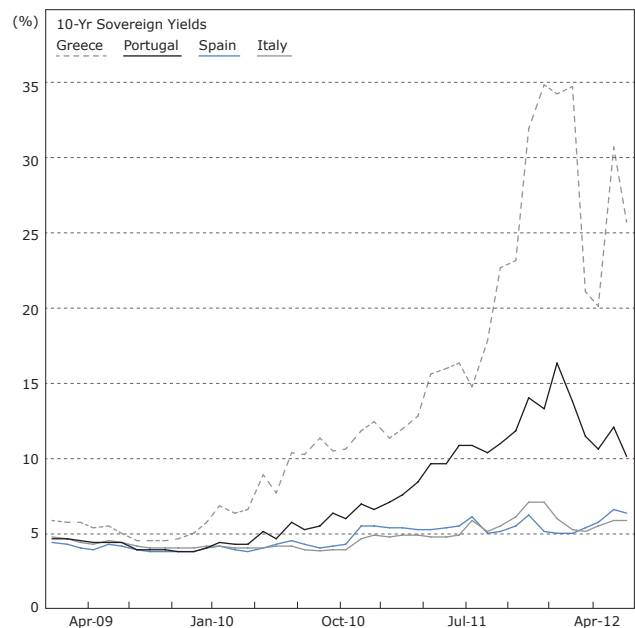
Capital markets now appear to be driving the crisis in Europe to a head as interest rates, and hence the cost of financing the deficits of the European offenders, have become unsustainably high. Investors are increasingly skeptical of “solutions” which are nothing more than political half-measures and have driven peripheral European sovereign debt yields to euro-era highs as shown in Chart 4. These high rates have effectively shut out the worst offending countries from the private credit

Chart 3: Greek Economy in a Depression



Source: US Department of Labor, Bureau of Labor Statistics,

Chart 4: Bond Vigilantes are Attacking Europe’s Periphery



Source: US Department of Labor, Bureau of Labor Statistics,

markets. Even Spain, Europe's fourth largest economy, now finds itself at the mercy of unsustainably high financing rates with 10 year yields reaching over 7%.

Unfortunately, there is no easy way out. Many analysts still believe that Euro zone leaders will find a way to muddle through and preserve the common currency by creating a true fiscal union similar to the United States. However, just as many analysts believe that the cultural and ideological divide is too large to be bridged. For example, Françoise Hollande, France's newly elected President, recently dropped their retirement age back to 60. What do the Germans think of France's change while they still have to work until the age of 67? Just wait until the Germans are asked to guarantee the debt issued to fund the deficit spending that will be required to support these entitlement payments.

The good news for investors is that the European problems have been on the front page of nearly every newspaper for the last two years and the market has begun to embed this uncertainty into valuations. Further, the risk of a "surprise" event that has not been contemplated by global leaders and capital markets is quite low. This is not to suggest that these events will cease to create market volatility, but simply that these issues are becoming much better understood by market participants.

The Diminishing Effectiveness of Central Bank Efforts

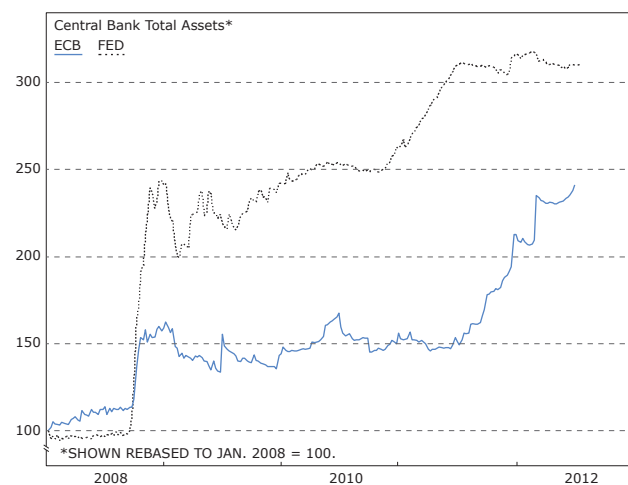
Whatever solution is found, it is clear that central bank policies are becoming less effective. Over the last several years, central banks around the world have embarked on experimental policies that are unprecedented in both scale and approach. While some analysts have argued that the economy would be far worse without such efforts, it is fair to say these efforts have done little to produce strong economic growth. Worse still, it seems

the effectiveness of these repeated programs is diminishing with each new effort.

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Early in July, the European Central Bank, the Bank of England and the People's Bank of China all announced additional easing programs within the span of an hour and the market's reaction was simply to shrug. It's a clear recognition that additional easing or other monetary policy measures alone will not solve the structural problems facing the global economy. However, despite some recognition of increasing policy impotence, most pundits believe that central banks will continue to try to have a positive impact. Chart 5 shows how U.S. and European central bank assets have exploded since the beginning of the financial crises. Today, the U.S. Federal Reserve owns nearly 20% of all outstanding Treasury bonds and over 50% of all outstanding mortgage-backed securities. We remain concerned about the ability of central banks to unwind these policies without dire consequences.

Chart 5: Central Banks Continue to Expand Balance Sheets to Support the Economy



Source: © BCA Research 2012

In the end, central bank policies will not solve the crisis of too much debt and not enough growth in the developed world. The reforms must come about by elected leaders making very difficult choices and compromises within the political process. Unfortunately, the solutions to a deleveraging crisis often involve short-term sacrifice for long-term benefit. These decisions are typically difficult in democracies with short-term election cycles. Our current problem is compounded by a lack of leadership around the world. For these reasons, we believe it will be a long time before real reform is enacted and the global economic environment shows marked improvement.

Capital Market and Investment Implications

Looking forward, we expect stimulative central bank policies to continue for some time, as recent economic reports appear to indicate further weakening in U.S. growth. While monetary efforts have done little to improve economic growth, massive liquidity injections and zero interest rates have pushed investors to take on riskier assets in search of return. Chart 6 shows the strong positive

impact of the U.S. Federal Reserve's two quantitative easing ("QE") programs and the more recent Operation Twist on the performance of U.S. equities over the last few years. These unprecedented policies will very likely continue to distort capital markets, increasing risks for investors.

The Impact of the European Crisis on Capital Markets

While the European crisis is likely to dominate headlines well into the future, there is some reason to believe its importance to capital markets may diminish. Fortunately, market participants have become more accustomed to the ongoing cycles of panic, policy response, relief, disappointment and eventually back to panic once again. Anything other than the extremes of either a fully integrated-European solution (not likely in the near-term) or a full break-up of the euro are being priced into the expected range of outcomes by most market participants. Unfortunately, headlines will likely continue to keep market volatility levels elevated.

Equity markets have begun to reflect this ongoing uncertainty through declining multiples and

Chart 6: The Fed's Quantitative Easing Programs have had a Positive Impact on Equities



Source: Bloomberg

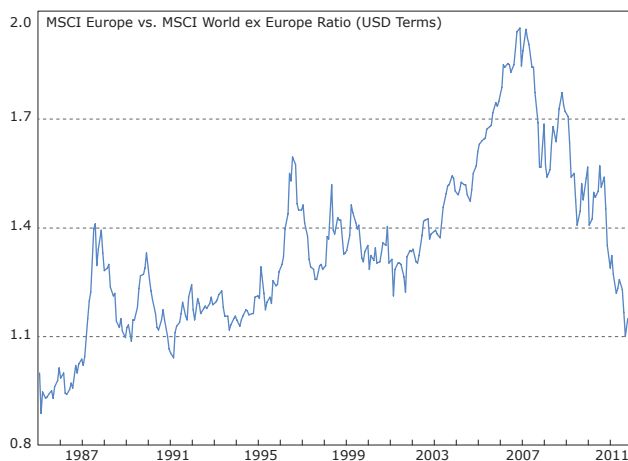
weaker performance. Over the last two years, European equity markets have increased only 13% compared with a very healthy 37% for U.S. equity markets and 28% for international markets beyond Europe. Chart 7 shows the relative appreciation of European stocks versus non-European international stocks over the last 25 years and their subsequent decline since the financial crisis. Evidencing this decline, European equities today trade at roughly 8.8x forward twelve month earnings compared with 10.1x for Asian markets excluding Japan and 11.9x for U.S. markets.

Investment Flows and Valuations

To look for opportunities and elevated risks, it can be useful to understand investor flows. Chart 8 shows net mutual fund inflows for equity, fixed-income, and money market funds. While these are somewhat crude categories, as each encompasses a wide variety of funds, they do provide useful general guidance.

Money market fund flows have been negative for over three years. It is probably not a coincidence that this is roughly the same time in which the U.S.

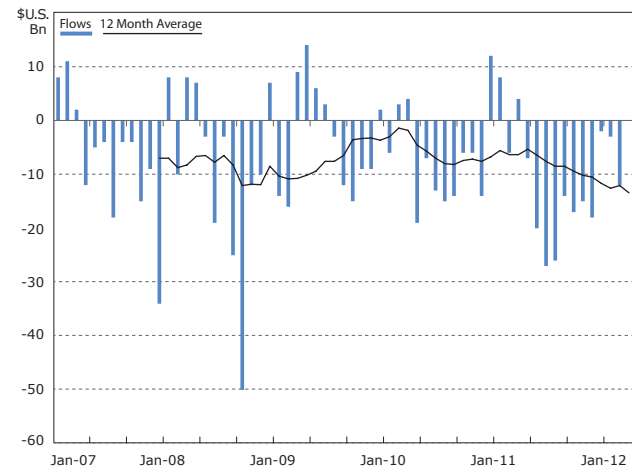
Chart 7: European Equities have Recently Underperformed their Developed Peers



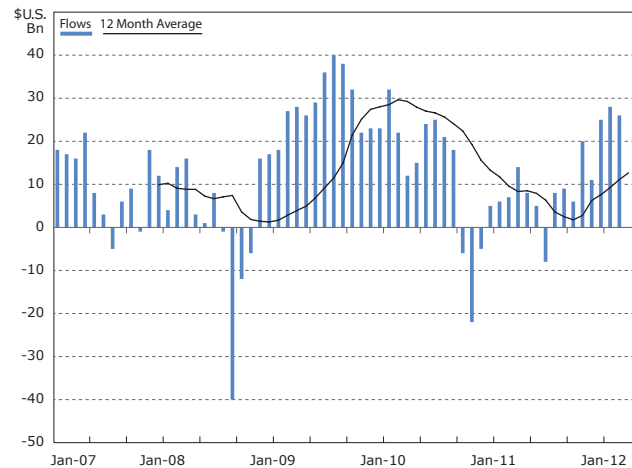
Source: Bloomberg

Chart 8: Investors Continue to Favor Bonds Over Equities

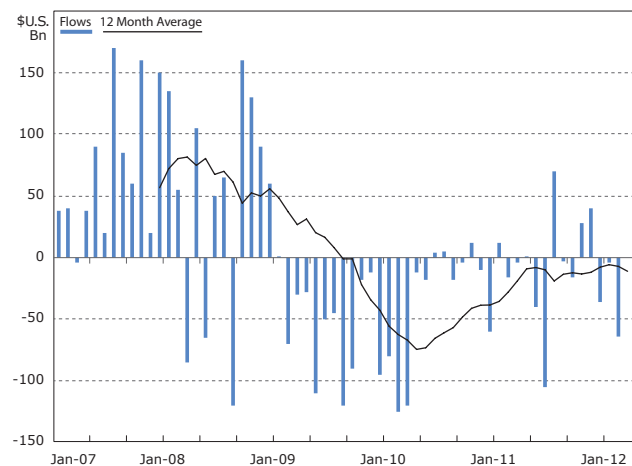
Stock Mutual Fund Net Flows



Bond Mutual Fund Net Flows



Money Market Fund Net Flows



Source: US Department of Labor, Bureau of Labor Statistics,

Federal Reserve began its zero interest rate policy, providing no benefit to investors who chose to leave their savings in cash. These policies have led to strikingly strong flows into bond funds over the last five years, as investors sought higher yields while retaining the perceived relative safety of fixed income. When these massive investor flows are combined with the intervention from central banks, it is not surprising that Treasury bonds and other safe haven sovereign bonds have reached record low yields.

On the other hand, despite the zero interest inducement, investors have consistently withdrawn from their equity investments over the last five years and recently recorded one of the largest outflows over any one year period in history. These outflows have contributed to the decline in equity market valuations and have resulted in equity markets becoming modestly more attractive relative to most other periods over the last 15 years.

A Bubble in Bonds? (Formerly Known as "Safe" Assets)

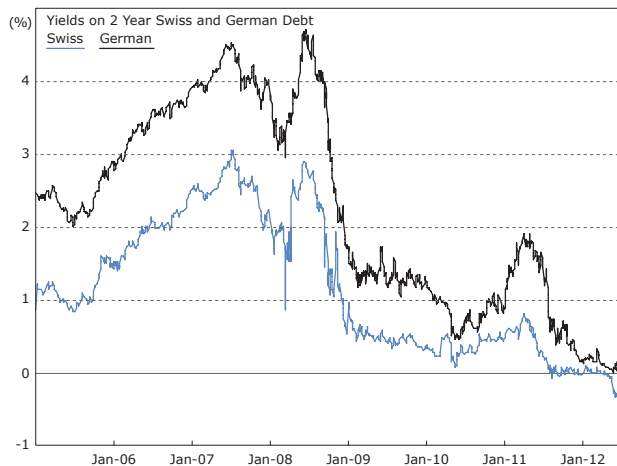
For several quarters, we have cautioned about the unattractive risk/reward balance in fixed income assets. U.S. interest rates have reached historic

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lows and real (inflation adjusted) treasury yields are negative out to 20 years. Additionally, as shown in Chart 9, two-year nominal Swiss and German yields are now negative. In other words, investors must pay these safe haven governments for the privilege of owning their bonds!

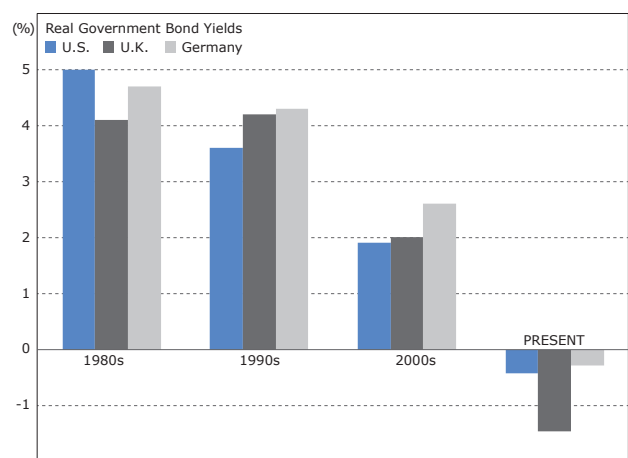
Over the last three decades as shown in Chart 10, real yields have typically averaged between 2% and 5%, but are now negative for most safe haven sovereign bonds. It is always easier to identify a bubble after it bursts, but many now consider U.S. Treasuries to be in a bubble. While most bubbles are built on irrational exuberance, this condition is built on irrational fears. Whether a bubble or not, the challenge for bond holders is that there is no precedent for these conditions, and it likely will not end well. Further, as distorted as these conditions appear, it is difficult to predict when they might end and bond prices could increase before they decline. For investors in these markets, the

Chart 9: Safe Haven Countries have Seen their Yields Turn Negative



Source: Bloomberg

Chart 10: In Real Terms, Government Bond Investors are Losing Money



Source: © BCA Research 2012

best case is that the U.S. Treasury markets remain massively distorted. The worst case is the unwinding of these markets will likely cause a significant sell-off and large losses for investors.

From a portfolio construction perspective, this presents investors with an additional challenge. Historically, safe haven sovereign debt was considered a risk reducing element in a portfolio, as these lower volatility assets also tended to exhibit negative correlations with equity markets, providing a sound investment for diversification purposes. At current prices, "safe" sovereign bonds, particularly those with longer maturities, are very risky investments indeed. In a world where correlations are already elevated, eliminating one of the few remaining diversifying assets due to its valuation and rising risk profile further complicates the investor challenge.

Equity Markets

Historically, "safe assets" equated to government bonds, which provided certainty of principal and stable cash flows. Today, it is global corporations that exhibit growing revenues and sustainable cash flow generation. While equity investments do not provide safety in a traditional sense (i.e., lower volatility and certainty of principal return), they may provide investors with the best chance of protecting the real purchasing power of their assets over the coming years. Corporate fundamentals may be the relative bright spot in the global economy, but this is only half the battle. Future equity market returns have historically been highly dependent on the price an investor pays for these assets.

BCA Research recently performed a historical analysis of equity markets to identify the characteristics for periods of sustained strength and weakness. Over the last century, equities have enjoyed three sustained periods of strong positive performance (1920-1928, 1948-1968 and

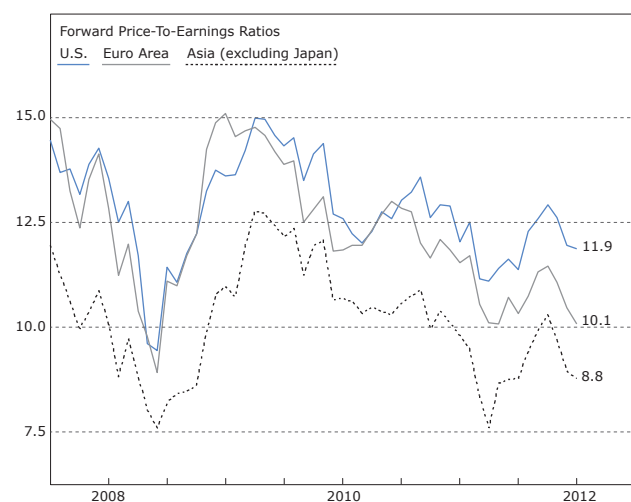
1982-2000). Each period began when the market was very cheap, with price-earnings multiples in single figures, and ended when valuations were elevated. In other words, multiple expansion has been a critical aspect of every secular equity bull market in the last century.

Additionally, each of these periods was characterized by a global environment that was generally viewed as improving; two were in the aftermath of world wars and the third occurred after the fall of communism. Today, it is safe to say that we are not in an environment of global stability. Additionally, two of these periods benefited from declining interest rates, whereas today we see limited prospects for a sustained further decline in interest rates. It is therefore unlikely we are on the verge of a secular bull market in equities.

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Today, as shown in Chart 11, the S&P 500 trades at a reasonable 11.9 times forward earnings. As valuations are not excessively high and the macro

Chart 11: Equities are Trading at Reasonable Valuations



Source: IBES

environment is not likely to get much worse, equity markets are a reasonable choice for some portion of an investment portfolio, particularly for investors able to tolerate the high volatility likely to be present in these markets over the next few years.

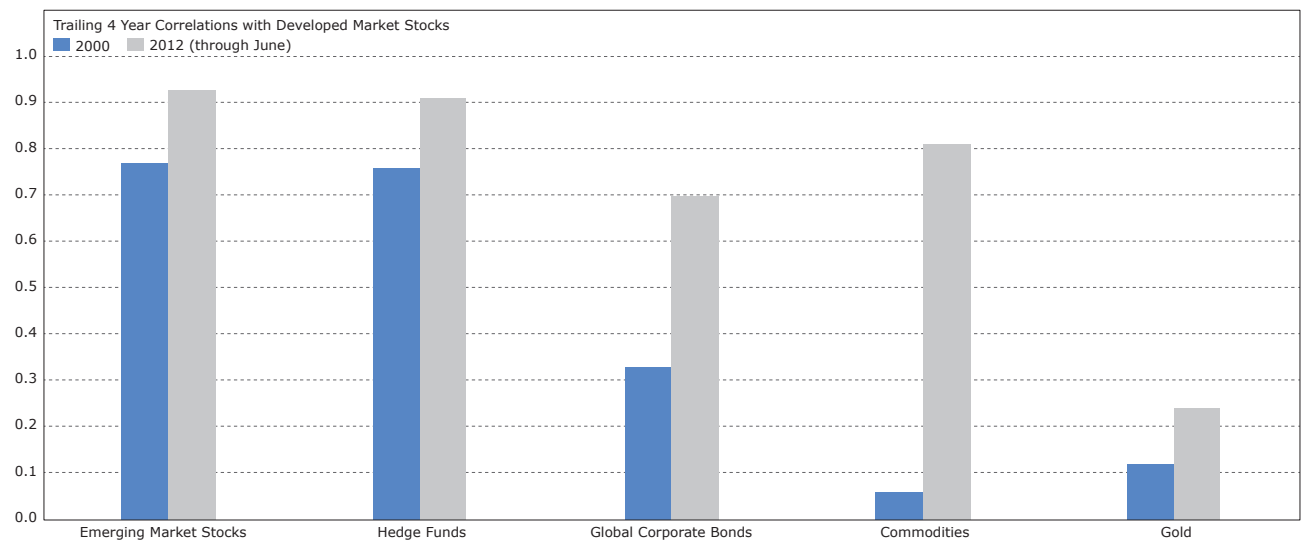
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Investment Themes

Our primary investment concerns continue to be elevated market volatility created by macro uncertainty and the current high levels of correlation among asset classes. Chart 12 shows the increased correlations between developed market equities and a wide range of asset classes. Unfortunately, diversification provides less protection during periods of elevated correlation like we are currently facing. The combination of high correlations and elevated market volatility poses a significant challenge, as the effectiveness of investors' primary risk management tool has been reduced. Beyond these broad concerns, we are focused on several specific ideas.

- It is important that investors carefully construct portfolios to withstand volatility and enable them to remain invested through market troughs, though it may be uncomfortable at times. To that end, increased cash levels can provide some measure of protection. Investors must recognize that investments in cash are facing a certain loss of real purchasing power, as yields are close to zero. However, higher cash allocations can be particularly valuable for investors who draw on their assets for living expenses to ensure that selling assets to raise cash does not occur during a market trough.
- Fixed income assets provide investors with an uninspiring risk/reward trade-off. Investors receive little current compensation and bear significant risk of a reversal of central bank support and recent investor inflows, which could lead to investment losses. However, high quality fixed income is one of the few remaining diversifying assets and while the U.S. continues to be viewed as a safe haven market, modest allocations can provide portfolios with some

Chart 12: Increased Correlation Across Asset Classes Reduces Effectiveness of Diversification



Source: Bloomberg

measure of reduced volatility and protection against global market shocks.

- The tension between macroeconomic risks and improving corporate fundamentals make equities difficult to evaluate. While valuations appear reasonable in a historical context, they are not at the overly attractive levels that have historically preceded bull markets. In conjunction with an uncertain macro environment that may last for years, we see no indications that we are at the beginning of the next secular bull market in equities. However, maintaining some exposure to equity investments will allow investors to participate in improving corporate productivity and profitability. On a risk/reward basis, market-leading businesses with quality balance sheets may be one of today's more attractive investment opportunities in the global capital markets.

Our primary investment concerns continue to be elevated market volatility created by macro uncertainty and the current high levels of correlation among asset classes.

- Within equity markets, over the last several years we have built exposure to emerging markets. These markets continue to mature and better reflect the increasing economic trend of increased discretionary spending by the burgeoning emerging market consumer class. In 2011, weakness in emerging market valuations allowed us to move further down our multi-year path of increasing our exposure. More recently, European equities have become relatively more

attractive, as markets have embedded the uncertainty over the future of the European markets. We recently made a new investment in this area with a manager who has proven to be quite adept in these markets. This has slowed our long-standing desire to increase exposure to emerging markets, at least temporarily.

- We remain cautious on commodity exposure despite the very aggressive policies of central banks around the world. While liquidity is abundant, it appears unlikely that global growth will accelerate dramatically in the near future. On the other hand, ongoing accommodative strategies are likely to continue to debase our paper currencies. As protection, we continue to recommend investors own modest amounts of gold, which we view as an alternative currency. While gold is very difficult to value, it does have a history of performing well during periods of currency debasement and is one of the few "lightly" correlated assets remaining in the world, which should provide some measure of portfolio diversification.

A Final Note on Cautious Portfolio Construction

We expect to continue living in a volatile world with modest return expectations across a wide range of asset classes. History has shown that investors who stretch for extra returns in these environments often assume additional risks that can cause significant losses in their portfolios. Accordingly, we continue to recommend that our clients maintain a very balanced approach in response to macro risks and high volatility.

About Gresham

Formed in 1997, Gresham Partners LLC is a nationally recognized, independent wealth management firm serving select high net worth individuals and families. Known for its commitment to delivering superior investment performance and highly personalized wealth planning, Gresham's client focused solutions feature hard to access managers without the conflicts typical of other firms. With over \$3.5 billion under management, Gresham's Risk Conscious® investment platform and holistic planning are focused on preserving and growing clients' assets. The firm's team of highly skilled professional advisors allows families greater freedom to pursue career and personal interests.

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