

Policy makers in developed economies are likely to remain accommodative, as domestic employment and growth concerns will dominate our trading partners' concerns regarding the debasement of the U.S. dollar. The very solutions aimed at solving the crisis, may be accelerating many of the secular changes that guide our long-term investment activity. We remain concerned about the wide divergence of inflationary expectations, the potential debasement of the dollar and the long-term secular shift of global economic growth to a series of emerging economies away from developed nations largely responsible for driving economic growth over the last fifty years. In this environment, which may possibly last for a number of years, we expect market volatility and the potential for extreme market outcomes to remain higher than usual.

In the near-term, the primary question facing the economic recovery is one of sustainability. With the amount of liquidity and stimulus pulling us forward, the real surprise would be if the economy had not yet exhibited some sign of recovery. Corporate earnings have turned positive over very depressed earnings one year ago, but earnings quality remains near all time lows and revenue growth is somewhat anemic. We believe unemployment and underemployment will continue to drive the needed consumer deleveraging and create headwinds for developed economy growth for years to come. In such an environment, we remain concerned that elevated liquidity due to ongoing stimulus may lead to asset bubbles. Additionally, the fragility of the economic recovery will present policy makers with conflicting indicators, which may lead to policy mistakes and create the needle needed to pop these bubbles.

Secular Outlook

Now that capital markets and the financial system have reverted to some form of tenuous equilibrium, we once again focus on the long-term path of secular change. The attention of governmental officials over the last 18 months was necessarily focused on ensuring financial solvency and avoiding a return of Great Depression conditions. Meanwhile, the underlying secular changes we identified prior to the recent crises have progressed and perhaps accelerated due to the impact of the crisis and the implications of the solutions. These secular changes, along with a few cyclical opportunities, which we describe below, will present attractive investment opportunities, as well as new risks, to our clients. However, these changes will also likely challenge investors' conception of equilibrium and portfolio construction paradigms.

Inflation and Dollar Debasement

Policy makers in developed economies are likely to remain

accommodative, as domestic employment and growth concerns will dominate our trading partners' concerns about the debasement of the currency. Additionally, the projected path of U.S. deficits is expected to lead to debt levels not seen since World War II, leading many to believe accelerating debt burdens will add to the dollar debasement concerns. After years of investing in a declining and predictable inflationary environment, we now face widely varied expectations and the significant risk of higher future inflation.

Divergent Economic Growth Favors Emerging Economies

We expect future economic growth in emerging economies to diverge, but not entirely decouple, from developed nations. The developed world's debt fueled consumption binge of the last three decades has likely ended, with zero interest rates and over-levered consumer balance sheets. A systemic deleveraging will act as a strong headwind for consumption-driven, developed economies such as the U.S. On the other hand, emerging economies are likely to grow at consistently higher rates. We expect continued maturation and openness in the capital market systems of these countries, providing an improved investment landscape through which risk-conscious investors, such as Gresham, can capitalize on these trends.

Debt Market Dislocations Continue to Create Opportunities

Credit spreads have returned to levels more consistent with historical norms and, in the process, created extraordinary returns for investors recently. We believe the ongoing deleveraging of private borrowers and slower economic growth in developed economies will create attractive investment opportunities for specialists in this area. We continue to emphasize distressed debt strategies as a core element of our equity exposures despite recent credit spread tightening.

Bubbles, Tail Risk and Interventionist Tendencies

While the capital markets have recovered significantly, many of the fundamental problems that created the recent crisis remain. Banking crises tend to be protracted affairs and history reveals that not a single such incident resulted in a "V-shaped" or quick recovery. Our concerns are elevated due to the highly accommodative stance of developed country central banks, which has created significant liquidity and reflatd many capital markets. Given these conditions, we are once again on alert for bubbles forming. Politics and government policy are growing increasingly important, as the trend toward interventionism, regulation and activist investment through sovereign wealth funds is increasing. This is a dangerous combination of bubbles and pins (policy mistakes and non-economic interventions), which lead us to be particularly alert for extreme market events or so called "tail" risks.

Inflation

The single most important question for investors to get right is whether we will face inflation or deflation. Many asset classes behave differently depending on the inflationary environment, leading to vastly different portfolio outcomes and, hence, portfolio construction concepts. Since the early 1980s, stable and declining inflation expectations presented investors with a relatively benign investment backdrop. Today, we face widely divergent views about the future path of inflation that lead to significant uncertainty and very different portfolio construction possibilities.

All things equal, inflation is created when too much money and credit are chasing too few goods and services. In some cases, this excess liquidity takes hold in the prices of goods and services, resulting in CPI inflation like we saw in the 1970s. In other cases, this excess liquidity takes hold in asset prices, such as stocks, bonds or real estate.

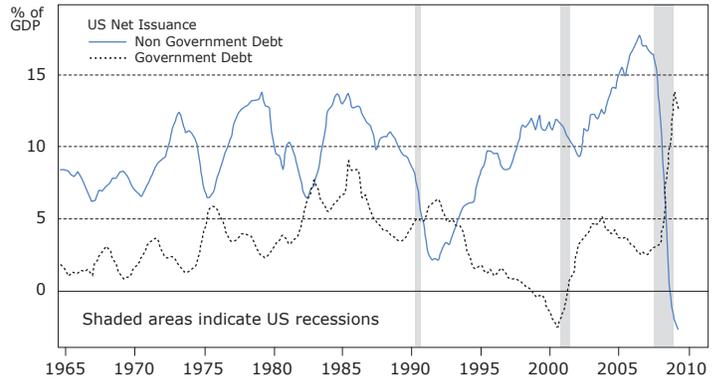
However, all things are not always equal. In a normal environment, the amount of money now in the system would very likely be leading to massive inflationary problems. However, we have seen cases, such as Japan, where massive monetary and fiscal stimulus do not produce inflation. In fact, the U.S. government appears to be merely filling the GDP gap left by retreating consumers (see **Exhibit 1**).

Additionally, the Fed's reflating efforts, to this point, do not appear to be making their way into the real economy. **Exhibit 2** shows that, while the monetary base has increased in unprecedented fashion, money velocity and, hence, real economic activity remains muted. Capacity utilization is reaching all time lows and unemployment will likely continue to rise. With monetary stimulus linkage to the real economy limited, the combination of slack labor and capital resources, will likely forestall inflationary pressures for some time. However, when the linkage is restored, this a level of stimulus is likely to create significant inflationary pressure unless it is removed at just the right moment. Accordingly, while we expect deflation concerns to dominate developed country policy response in the near-term, we believe inflationary pressures will eventually build, likely beginning in emerging economies and possibly spreading to a broader, global phenomenon.

On a related note, investors face similar concerns regarding the debasement of the U.S. dollar. In the likely absence of the political will to shrink the fiscal deficit and slow debt issuance, and when combined with the "off balance sheet" Medicare and Social Security obligations, many are raising questions about the legitimacy of claims issued by the U.S. government.

Exhibit 1: U.S. Net Debt Issuance

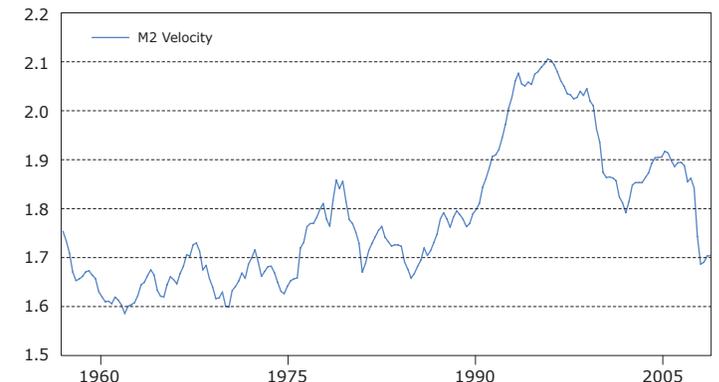
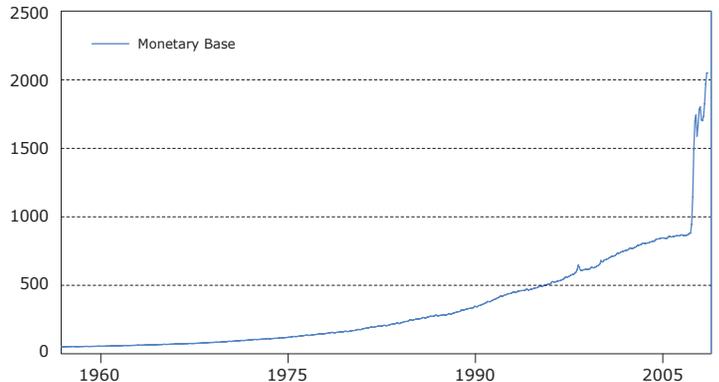
The U.S. government appears to be merely filling the gap left by the retreating consumer.



Source: © BCA Research 2010

Exhibit 2: Monetary Base and Money Velocity

The Federal Reserve's efforts have not yet reached the broader economy. Likely resulting in lower inflation...for now.



Source: Bloomberg, St Louis Federal Reserve

Is a dollar crisis imminent? The answer is likely “no.” Foreign central banks fear a decline in the dollar that would cause large losses on their reserve holdings, which they hold primarily in dollars and dollar-denominated assets. Additionally, many of these countries rely on the U.S. markets for their export industries and an increase in their local currency relative to the dollar would erode their competitive position, local growth prospects and employment outlook. Lawrence Summers recently described this nervous stalemate as “a balance of financial terror”, and détente is likely to prevent a dollar collapse.

Longer-term, the trend away from the dollar as the world’s reserve currency has commenced. We see governments moving to reduce their dependency on U.S. dollar reserves and some countries, including China, have already begun to form bilateral trade agreements that allow for settlement in non-dollar currencies. The likely result of these changes will be the elimination of the U.S. dollar as the primary reserve currency and standard of global trade in favor of a more balanced, possibly multi-currency solution. These changes will take time, as the U.S. is, and will remain, the largest economy in the world for years to come. Unfortunately, these changes will ultimately inflate the cost of imported goods and increase the cost of capital, reducing the potential growth rate of the U.S.

Implications

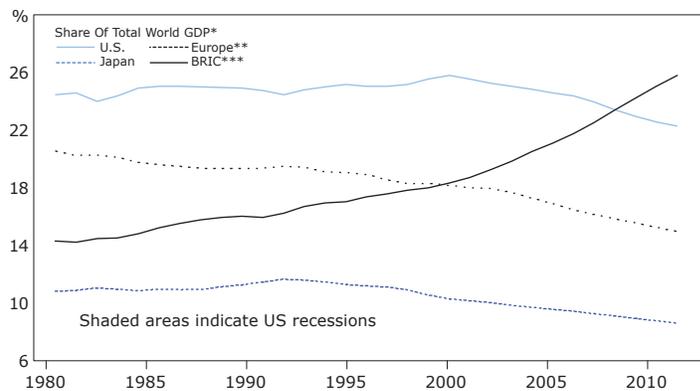
At this point, we do not believe a single magic bullet exists to solve our concerns about inflation and the debasement of the dollar. The solution is likely a collection of strategies that, in aggregate, will have a positive influence on portfolio values over time.

When considering protecting against the debasement of the dollar, one of the first questions we must answer is, “relative to what?” Many other freely exchangeable fiat currencies are similarly in doubt, as they also face large deficits and increasing debt levels. Diversification along these lines is only part of the solution. To this end, we have long advocated significant exposure to non-U.S. equities and have a strong preference for these managers to own their securities in the underlying currencies.

Relatedly, we are actively exploring direct currency hedging programs designed to hedge dollar declines. However, much of the currency industry expertise is focused on short-term, trend-following trading programs that won’t explicitly protect against dollar declines and may actually be long dollars for significant periods in pursuit of short-term profits. This short-term trading program is not the type of solution we seek.

Other currency-based solutions present investors with a

Exhibit 3: BRICs Relative Share of Global GDP



* On Purchasing Power Parity basis, includes estimates. IMF data.
 ** Includes France, Germany, Italy and the U.K.
 *** Includes Brazil, China, India and Russia. BCA estimate for Russia prior to 1992.

Source: © BCA Research 2010

two-way proposition. If the dollar were to decline, these strategies would be profitable and protect against asset erosion. However, investors would face the possibility for significant losses should the dollar appreciate. This is simply a currency bet, not a protection-oriented strategy.

Recently, some have focused on gold as an alternative store of wealth and several high profile investors have launched dedicated gold funds or gold-denominated classes of existing funds. Many investors still view gold as a quasi-money standard despite the elimination of all formal linkage to currencies nearly forty years ago. Unfortunately, since the 1980s, the correlation of gold and inflation has been close to zero and the limited supply and unusual demand dynamics have created an investment pattern that is driven as much by psychological connections as fundamental factors. This creates price volatility and the potential for unintended consequences for investors. Therefore, while gold exposure may be part of the solution, it is too unreliable to be the only solution for clients.

Divergent Growth Favors Emerging Economies

Many economists now support the thesis that we are in the midst of a fundamental realignment of global economic influence, which will include a gradual handoff to the BRICs and other developing countries that previously had little systemic influence. **Exhibit 3** illustrates the rapidly growing importance of the BRIC’s in world trade. Moreover, trade increasingly occurs among developing nations rather than relying on exports to developed countries, allowing for true divergence between developing and developed nations.

While capital markets are highly interconnected in the short run, developing economies appear to have decoupled to some degree from developed nations, as most analysts

believe these secular trends will boost economic potential and actual GDP growth over the coming years. Higher growth rates can lead to opportunities that are more attractive if we can capture these tailwinds at reasonable prices.

Relatedly, developing nations, especially the BRICs, have begun to assert their growing power. For example, the G-7 once dictated economic affairs, whereas it now appears likely that the G-20 will be the dominant economic forum for the future. Changes of this magnitude typically generate friction between nations. We expect to see protectionism and interventionist tendencies by governments, including the U.S., increase in the coming years. This will increase the likelihood of unexpected events and will keep overall market volatility elevated.

With broader perspective, we expect that U.S. investors' portfolios will begin to look much more like those of other international investors, who have exhibited much less home-market bias, somewhat by necessity. As the U.S.' share of the global economy and global equity market capitalization shrinks, a neutrally weighted global equity portfolio will naturally shift toward international equities and, within this international allocation, toward emerging market equities. While most international benchmarks rely on market capitalization to determine country weights, we will also consider broader economic activity metrics, such as share of global GDP and contribution to global GDP growth, which better reflect these trends, into strategic (long-term) recommendations for our clients' international exposure.

Implications

We continue to seek ways to increase our exposure to emerging markets. Unfortunately, emerging markets typically present additional volatility and higher risk of principal loss, which leads us to increase our exposure cautiously. Most importantly, we will make such changes focusing on risk considerations, rather than return maximization, primarily by finding managers who share our risk conscious approach.

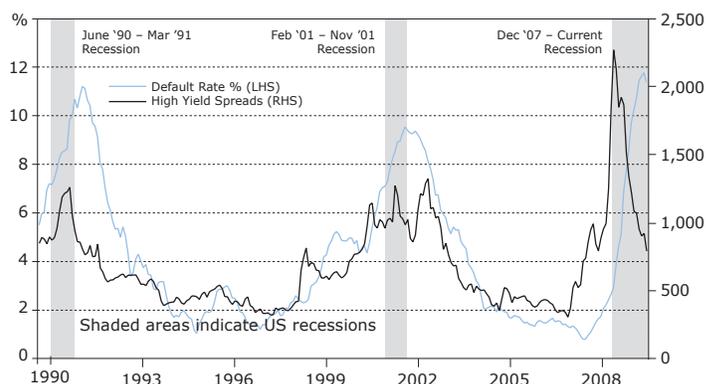
As discussed earlier, we prefer the managers of our international exposures to leave currency unhedged as protection against a depreciating dollar. As our preference continues to strengthen, we will not consider a dedicated international equity manager who is unwilling to manage in this fashion. Further, we will weigh this consideration more heavily in evaluating whether to retain existing international managers.

Debt Market Opportunities

We have allocated significant portions of our equity assets toward distressed debt. The debt markets provided a very attractive investment opportunity in the Fall of 2008, as credit spreads widened to historic levels. During the middle

Exhibit 4: Historical Credit Spreads and Default Rates

While spreads have tightened to near pre-crisis levels, many expect default rates to remain elevated for some time.



Source: CS HY Index, Moodys

portion of 2009, credit spreads tightened back to pre-crisis levels, producing attractive returns for our clients.

With the compression of spreads, we must ask ourselves if the debt market opportunity is behind us and if we should reallocate capital to other areas. Typically, default rates continue to rise well after the end of a recession, as companies exhaust their reserves while still facing pre-recession debt burdens and reduced revenue levels (see **Exhibit 4**). The current cycle is somewhat unusual in that the initial spike in credit spreads was driven by illiquidity and forced selling by market participants, rather than a fundamental concern about underlying company defaults. Recent spread tightening is a reaction to the normalization of market activity rather than an indication that the distressed cycle has ended.

We, along with our managers who specialize in this area, believe we are just now entering the heart of the distressed cycle and the opportunities will may equal or exceed those of past cycles.

Implication

We plan to maintain our investments in this area through the remainder of the cycle and recently added a manager to our roster who we feel is particularly experienced and well-suited to extracting returns in such an environment.

Interventionism, Bubbles and Tail Risk

While we are not overly concerned about CPI type inflation in the near term, we are concerned about asset inflation, as the massive liquidity required to ensure solvency for the financial system far exceeds the needs for a stabilized economy. Last year, many emerging equity markets

increased significantly, some over 100%, which may be an example of emerging asset bubbles. Closer to home, many analysts believe that the current equity rally has surpassed economic fundamentals and is now being driven by liquidity. It is too early to say if this will continue on the path to become a bubble, however, the conditions seem conducive.

Markets can remain overvalued for extended periods and history suggests the federal policy decisions are often the bursting pinprick. Unfortunately, the U.S. economy appears to be unusually susceptible to policy errors, which when combined with the potential for bubble formation, might lead to extraordinary consequences. The economy has become even more highly leveraged to interest rate changes and the Fed will find the choke point earlier once it begins to tighten interest rates. In each successive case of tightening over the past 30 years, the consequences appear earlier and at lower interest rate levels, as one would expect with an increasingly leveraged economy (see **Exhibit 5**). This is why many believe the Fed is walking such a fine line and some skeptics compare the exit path to threading a needle. We believe this is the reason why such large divergence exists between those worried about inflation and those worried about deflation.

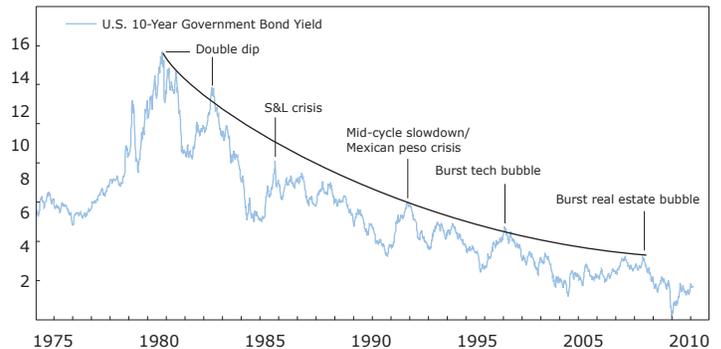
Implications

If, with perfect foresight, we could time our entry and exit points to correspond with the peaks and troughs of the fickle capital markets, the solution to this problem would be simple. Few investors (we have yet to meet one) possess this ability and the consequences of missing a small number of the more productive days or months in the equity market fundamentally alters the attractiveness of the asset class. Accordingly, our efforts will be focused on remaining invested, but doing so in a risk-conscious manner by finding managers that share our mindset and avoiding investments that adhere to benchmark-oriented mandates or other constraining parameters.

On the other hand, we believe the risks posed by investing in today’s market are higher than normal, leading us to believe additional protective measures are required. In 2009, we implemented a protective, options-based overlay strategy to provide “insurance” against a sharp monthly market decline. We believe the elevated risks in the market make it prudent to leave this protective hedge in place. Additionally, we are exploring alternative methods of protecting client portfolios against large drawdowns, or so called “tail risks”.

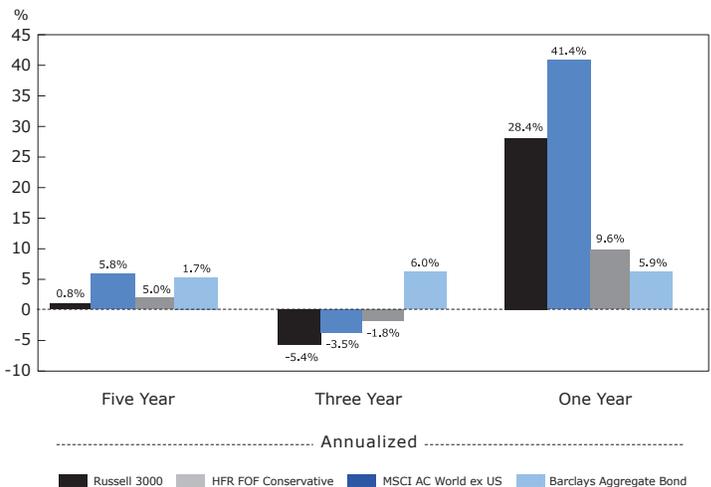
Exhibit 5: Interest Rates and Financial Crises

Fed tightening has precipitated crises at sequentially lower interest rate levels



Source: © BCA Research 2010

Exhibit 6: Historical Market Performance



Quarter In Review

Capital Market Review

As shown in **Exhibit 6**, equity markets continued their extraordinary run during the fourth quarter last year, with the S&P 500 increasing an additional 5.9%. The index has now increased nearly 60% since the beginning of March, bringing 2009 performance to 27%. Within the equity markets, it is worth noting that financials were the only sector to decline during the quarter, indicating that the troubles in this sector may not be quite over.

Overseas markets also performed well, increasing 3.7% for the quarter, bringing 2009 performance to 41.4%. The strongest performers were once again emerging markets, which, in aggregate, increased 8.5% for the quarter and

have now increased nearly 80% for the year. China, after softer third quarter performance, once again led most markets, increasing 19% and 97% for the quarter and year-to-date periods, respectively.

The dollar, after relinquishing most of its 2008 gains during the first three quarters, remained relatively stable during the fourth quarter. In such an environment, returns to investors were similar regardless of the decision to hedge currency exposure in their investments.

Bond performance was mixed, with slight increases in Treasury yields creating modest losses of just over 3% for the quarter. However, these losses were offset by continued credit spread compression, which left the overall bond market up 0.2% during the quarter. The biggest winner was once again high yield bonds, which continue to recoup significant losses from 2008, gaining 6% for the quarter and 58% for the year. Yield spreads in many sectors have now returned to pre-crisis levels.

The hedged strategies area was up just under 1% for the quarter, bringing 2009 returns to just under 10%. This was a sector where effective implementation made a significant difference in performance, as we discuss later. While performance in private equity and real estate are always anecdotal given the lack of reasonable benchmarks, we believe these markets continue to diverge. Real estate continues to soften as operating performance lags the economy and the resolution of over-levered assets is slow, the combination of which continues to have a depressing effect on property values. On the other hand, private equity transactions are accelerating, albeit from very low levels, and valuations appear to have improved, largely in sympathy with the public equity market rebound.

Economic Review

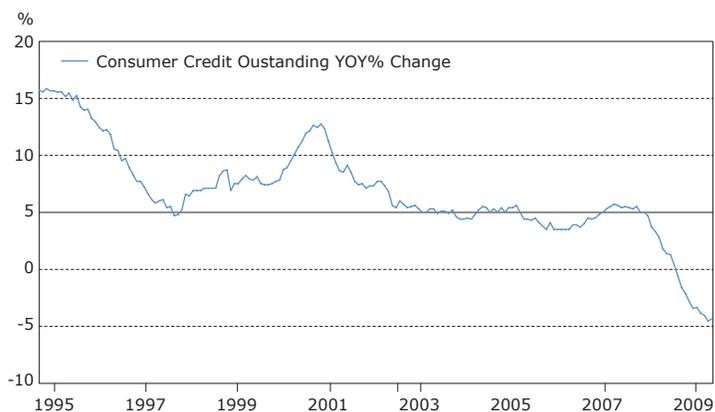
The primary question facing the economy is one of sustainability. With the amount of liquidity and stimulus pulling us forward, the real surprise would be if the economy did not

exhibit signs of recovery. As one analyst put it, the tow truck (government stimulus) is pulling the car (economy), the question is what happens when the car needs to run on its own. While GDP growth has been positive the last two quarters, indicating a likely technical end to the recession, some analysts estimate that government stimulus and the rebuilding of inventories, which counter-intuitively add to GDP growth, account for more than 100% of the growth.

Corporate earnings have turned positive and are posting strong growth compared to very depressed earnings one year ago. However, earnings quality remains near all time lows, as companies continue to take "one time" write-offs,

Exhibit 7: Consumer Credit

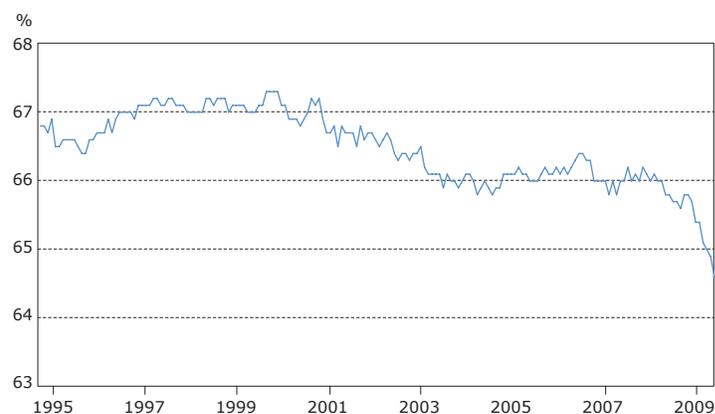
Consumers, who drive 70% of the U.S. economy, continue to retrench



Source: Bloomberg

Exhibit 8: Labor Force Participation

While official unemployment statistics appear to be stabilizing, actual labor force participation is telling a different story



Source: Bloomberg

which affect actual reported earnings, but do not affect operating earnings. While earnings growth is high, fourth quarter revenue growth is estimated at only 7%, both of which are based on the same prior-year depressed base. Without top-line revenue growth, one-time earnings fixes and productivity enhancements will eventually cease to provide a boost to earnings much beyond the slower top-line growth.

Of equal concern, consumer debt deleveraging headwinds and persistent unemployment appear to be having an effect on U.S. consumer spending. **Exhibit 7** shows that consumer credit continues to decline, creating contractionary headwinds. This dynamic is not likely to change, as many analysts believe the unemployment rate understates the

size of the problem due to the increasing number of discouraged and underemployed workers being dropped from the official labor force data. In contrast to the improving official unemployment figures, labor force participation rates (see **Exhibit 8**) show an unemployment problem that continues to deteriorate, which means that income, consumption and, ultimately, GDP are, at best, likely to grow slowly.

Balancing the decent headline numbers with disturbing underlying fundamentals leaves us with more uncertainty. David Rosenberg recently noted that the chief policymakers of the Federal Reserve (i.e. the people arguably in the best position to know) have widely divergent views on growth and employment with one official estimating a return to full employment over the next two years and one official estimating the U.S. economy will have borderline deflation. This level of dispersion and uncertainty tends to create an unstable base for capital markets, as investors ride the emotional roller coaster of conflicting economic data.

The global growth picture appears to be improving, particularly in emerging markets. China has led the recovery, reaping the benefits of applying the earliest and relatively largest stimulus program of any major economy. China's domestic consumption continues to be strong, providing solid footing for a self-sustaining recovery. In fact, the Chinese central banks recently began implementing braking measures to ensure their economy does not overheat and lead to unhealthy levels of inflation. This divergent growth pattern supports our longer-term secular view that higher growth rates are likely to be available outside of developed economies.

The simple fact that no economy in history has ever exited a banking crisis with a quick recovery should give everyone some pause. Accordingly, we remain cautious about the prospects for rapid recovery.

Asset Class Overview and Perspective

While capital markets have regained tenuous stability, investors now must assess the relative attractiveness of various asset classes in order to establish their long-term allocation framework.

Domestic Equity

While domestic equity markets rebounded strongly in 2009, the sustainability of the economic recovery and the continued growth of corporate earnings are important in justifying

current equity market levels. The current conditions are not highly conducive to the formation of the beginning of a secular bull market when compared with earlier periods.

International Equity

Consistent with our secular outlook, foreign markets, particularly emerging markets, are likely to present investors with higher growth opportunities. Relatedly, we remain interested in increasing our emerging market exposure cautiously, due to the higher volatility in these markets.

Bonds Markets

While credit spreads have compressed to pre-crisis levels, rendering most traditional credit markets significantly less attractive, we will retain our significant exposure to the distressed arena, where depressed pricing continues to present attractive opportunities. Municipal bonds have also recovered nicely, but intensive, original credit research is required of our managers given our growing concern over deteriorating municipal finances.

Hedged Strategies

Strong recoveries in equity and credit markets and the restoration of trading liquidity provided the backdrop for a strong year of performance and one in which the most capable managers distinguished themselves from the herd. While we believe the area is attractive in the near-term, we remain cautious due to the potential return of large, competitive capital bases and the possibility of higher tax rates, which would reduce the relative attractiveness if this investment area.

Real Estate

Real estate financing, the life-blood of transactions, remains challenging for investors. Additionally, real estate operating fundamentals in most areas continue to deteriorate, creating a difficult, but potentially fruitful, opportunity for investors. We remain pleased with many of our real estate managers, whose disciplined approach has left them with large uncalled commitments in the face of an increasingly attractive environment in which they can purchase assets.

Private Equity

Private equity markets are beginning to see signs of life, as transactions are starting to increase, albeit from historically low levels. Additionally, valuations are beginning to improve, largely in sympathy with the public markets, which some use for comparative valuation purposes. The secondary market remains attractive, despite the reduced panic selling that was prevalent a year ago.

Domestic Equities

U.S. stocks appreciated 5.9% in the fourth quarter and ended 2009 up 27%. Despite this strong finish to the decade, the past decade was the worst in recorded history, going back to the 1830s. In the last decade, U.S. stocks declined at an annual rate of 0.5%, slightly worse than the decade of the 1930s, in which stocks declined 0.2%. To some extent, the past decade was a reversal of the prior two decades, the 1980s and 1990s, which were the second and third best in history, during which U.S. stocks increased at a rate of 16.6% and 17.6%, respectively.

Looking at U.S. market sectors, technology led the way in 2009 by a large margin, with an increase of 61.7%, and materials were up 48.6%. The laggards were the "safe" sectors of telecommunications (+8.9%) and utilities (+11.9%) given the liquidity driven market of 2009, in which many of the riskiest stocks led the huge rally from the March low.

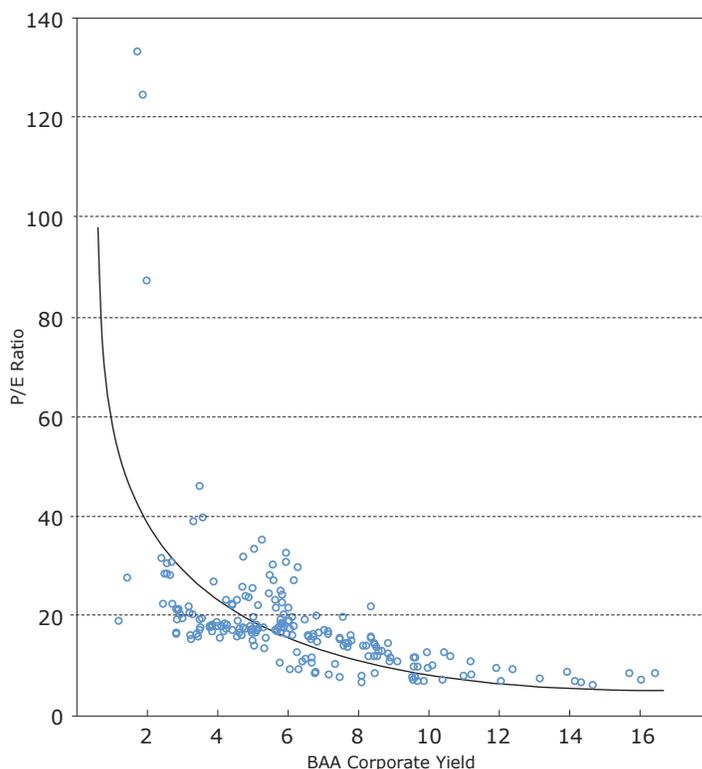
2009 was a year in which the worst performed the best. While the vast majority of stocks had a very good year, attributes like quality and size were relatively negative attributes. For example, the largest 50 stocks in the S&P 500 are up 22% while the smallest 50 rose 113%.

Both bottom-up and top-down analysts expect a large earnings recovery in 2010, currently estimated at 35% in operating earnings for the S&P 500. In part, this reflects the poor results of 2008 and 2009, in which earnings declined over 30% in aggregate. What weight one should put on such predictions is debatable. It is interesting that the estimated earnings for 2010 for the S&P 500 at about \$77 are nearly exactly what was expected in 2009. Instead, 2009 earnings are now estimated at \$56, a shortfall of nearly 30%. History indicates that earnings estimates tend to lag market recoveries. Most analysts believe we are at a point where the market requires earnings confirmation in the form of a continued recovery in profits to justify current market levels.

While earnings are difficult to estimate, putting an appropriate valuation on any given level of earnings is more difficult. Currently, the S&P 500 trades at about 15x the projected 2010 earnings estimates. Based on historical P/E ratios, this is considered a fair value by many. Those who are more bullish would say that P/E multiples could still be higher given current low interest rates. **Exhibit 9** shows that lower interest rates have often been associated with higher PE ratios. While it is true that unusually low interest rates are driving investors to seek returns in riskier assets, such as stocks and corporate bonds, the current level of interest rates has undoubtedly been depressed by the massive government intervention over the last two years.

Exhibit 9: Interest Rates and P/E Ratios

Lower interest rates, given government intervention, likely implied priceearnings ratios that are overly optimistic



Source: © BCA Research 2010

Given the uncertainty and risks mentioned heretofore, it is unlikely that current interest rates provide an adequate discount rate on earnings for these risks. Should trends in earnings and economic conditions disappoint, or markets simply focus more on the potential risks, we believe markets could decline significantly. One analyst noted that the recent rally may be the most distrusted rally of all-time.

The great debate is whether we are now in the initial stages of a new bull market or simply a temporary rally in a secular bear market which began in 2000. The last great bull market began in the early 1980s and lasted through the 1990s. It is interesting to note some of the differences between today's conditions and those of the early 1980s, leading us to conclude that the initial conditions are not conducive to forming a lasting market bottom and the beginning of a secular bull market.

- S&P 500 PE ratio (trailing 12 months) - 8x versus 20x
- Fed funds rate - 18% and only one way to go (down) versus 0% and only one way to go (up)
- Tax rates (highest marginal rate) - 69% and falling versus 35% and likely to rise
- Household debt as percent of disposable income - 62% versus 123%
- Government regulation - decreasing versus increasing

As an aside, there is a good chance that after a year in which the best companies dramatically lagged more vulnerable companies, the market is particularly well set up for long/short hedge funds. If markets have advanced too rapidly versus fundamentals, long/short funds' reduced market exposure will protect investors in the event of a market decline, which, combined with a market that more rationally sorts out the winners and losers, will increase the ability of these managers to add considerable value.

International Equities

Foreign stocks were up 3.7% in the last quarter, and ended 2009 up 41%. For the year, the decline in the U.S. dollar contributed about 9 percentage points to the return of a U.S. investor in foreign stocks. Europe outperformed Asia, + 36% versus + 24%. While Asian stocks were very strong, Europe's out performance was due to the depressing effect of Japan's large weight and its very poor relative performance, up 6%. Emerging markets were the strongest performer, increasing 78% for the year. Of the return in emerging markets, 16 percentage points was due to the decline in the U.S. dollar versus emerging market currencies.

Given the changes that we mentioned earlier in our overview, we continue to believe that foreign markets, especially the emerging markets, will continue to provide higher growth opportunities to U.S. investors, although some feel that valuations have become inflated. As investors have become more comfortable with the increased economic stability, better governance and growth rates of many emerging markets, valuations have increased and some believe that valuations in emerging markets are now 20% higher than those in developed markets. However, this data should be put in the context of an expected GDP

growth rate across emerging markets generally of about 8% versus less than half that rate in developed markets. We recognize that a bubble in emerging markets is quite possible, even probable, given their attraction in a world of very low interest rates and expected slow growth in many developed countries.

Among emerging markets, China has been most appealing to us for some time and we have created a growing allocation among both marketable and non-marketable investments to China. We agree with those who believe that the emergence of the Chinese consumer class will likely rank as the world's foremost economic event over the next decade and more. While we now have a material position among our marketable strategies in China, we have come to the view that private equity may be preferred to marketable investments given the need for stable, long-term capital to benefit from the very attractive long-term growth potential in China. Private equity must, by its nature, take a long-term view of its investments and is closely involved with the development of their companies and their products and management. Marketable investments, by contrast, can be highly volatile and the investor base of many managers can be quite unstable in reacting to these volatile public markets. This combination makes it very difficult for managers to run a business of marketable investment management when their investor base, and assets under management, can increase or decrease dramatically as markets rise and fall. Moreover, private equity should provide lower entry valuations and a much broader universe of companies in which our managers can choose to invest. For example, in China, most estimates place the number of publicly traded companies at around 5000, but private small and medium sized enterprises are estimated at around 30 million.

Japan remains the great anomaly among developed markets. Remarkably low valuations and inefficient corporate resource utilization and management create opportunities which, statistically, are very attractive. On a price/book basis, Japan is trading at a 45% discount to the U.S. Moreover, Japan's book value is generally of a higher quality as it consists almost entirely of tangible values and contains little goodwill. Given repetitive disappointments to investors in Japan, including us in recent years, the investing world looks at Japan with revulsion today. While we have reduced our direct exposure to Japan and some of our managers have reduced their exposure as well, areas which the world hates have a way of eventually surprising. Japan's markets contain a healthy number of the world's best companies and, if global growth surprises on the upside, Japan's export dominated economy and its strong Asian connection should benefit. If so, Japan could surprise a lot of investors.

Bond Markets

Bond markets largely reversed their performance trends from 2008. The bellwether 10-Year U.S. Treasury bond, 2008's largest gainer, declined by 3.5% for the quarter and nearly 10% for the year as investors shifted their focus to higher yielding segments of the bond markets. Similar to equities, lower quality bonds outperformed higher quality issues by a wide margin, with lower rated corporate high yield bonds returning 58% for the year compared to a 1% decline for AAA-rated corporate issues. Emerging market debt also performed well, returning over 27% in U.S. dollar terms for the year.

High yield corporate bonds have completely recovered their 2008 losses, as credit spreads, which reached historical highs during the credit crisis, tightened from over 1700 basis points to approximately 630 basis points during the year. As mentioned earlier, while credit spreads have tightened considerably and the economic outlook has improved, we continue to believe opportunities in distressed debt will be robust over the coming quarters. Distressed situations often lag the deterioration of business conditions by several quarters and may only reveal themselves when a company exhausts their refinancing options. The high levels of leverage remaining on the balance sheets of some businesses and the slowdown of operating conditions resulting from two years of recession will likely create future distressed restructurings or bankruptcy opportunities as debt maturities approach.

Municipal Bonds

High quality municipal bonds returned 7% for the year and have returned to historical valuation ratios compared to treasuries. Municipal returns were aided by a decrease in supply, due to the Build America Bond program, which offers issuers a more cost effective means to raise capital on longer-maturity debt. In addition, the municipal market demand strengthened, as investors looked to reallocate money away from money markets yielding close to 0%. For the year, investors poured a record \$75 billion into municipal bond funds.

The technical reasons cited above for the increased demand in municipal bonds are set in opposition to increasing concerns over the credit quality of a number of states and municipalities. Analysts are split in their assessment of widespread default risk in the municipal market, as the severity of fiscal problems will largely be offset by federal government transfer payments in the short-term and eventually through tax hikes and spending cuts surely to be enacted to cover budget gaps. Additionally, modern state laws contain a number of provisions designed to insulate bondholders during fiscal difficulties by impeding politi-

cians' ability to impair debt. Still, the risk of credit ratings downgrades has increased significantly. In response, we insist that our managers rely on their internal fundamental research efforts and focus only on the higher quality portion of their investment universe.

Hedged Strategies

Hedged strategies returned nearly 1% during the quarter and finished the year up 9.4%, as the sharp recoveries in the equity and credit markets provided a strong tailwind for many strategies. Anecdotally, we believe performance in the hedge fund space, as proxied by the HFR peer group, is not reliable since many of the larger, stronger managers do not report their results and conversely, many of the smaller weaker-performing managers cease reporting as they are begin to collapse.

Despite the broad recovery in the industry, performance dispersion between individual managers was very wide. One hedge fund research group estimates that just over half of all ongoing funds have fully recouped their 2008 losses, while on the opposite side, approximately 2,000 funds have been liquidated since the crisis began. Many of the worst performing strategies during the credit crisis, such as convertible and fixed-income arbitrage, became the top performers in 2009.

The strong performance of last year was aided by a large reduction in competitive capital. When the reduction of available leverage and disappearance of investment bank proprietary trading desks is included, the available amount of risk seeking capital available for hedged strategies remains greatly reduced. For the year, analysts estimate that investors withdrew over \$130 billion from hedge funds in 2009, although the pace of redemptions abated as the year progressed. In addition, strong performance more than offset the outflows and year-end assets under management amounted to approximately \$1.6 trillion, up nearly \$260 billion from the trough in March. Despite the improvement, total assets remain nearly 20% below the peak levels set in early 2008. The capital outflows resulting from the recent crisis have hedged strategies investors and managers seeking a new equilibrium with respect to fund terms. Managers are increasingly bowing to investor demands for greater transparency and modified fees in exchange for longer commitments of invested capital. In the near-term, we remain positive on hedged strategies given the superior level of talent in the industry and reduced asset

bases, which now allow managers more investment flexibility in less-efficient trading strategies. However, in the longer term, we remain concerned that large asset inflows will eventually strengthen correlations between hedged strategies returns and other major asset classes, reducing the diversification benefit provided to investors.

Real Estate

Unfortunately, the popular real estate indices remain useless. Most indices are backward looking and appraisal-based and incorporate new trends slowly. Even transaction-based indices, which more rapidly reflect price changes, are unreliable as transaction volume is at historic lows. As a result, our commentary reflects anecdotal information we are receiving from our managers.

Broadly speaking, real estate assets require deleveraging and recapitalization. Functioning debt markets are essential to this process and, although they are improving, debt markets for real estate assets are largely nonfunctioning for transactions approaching \$50 million or more. Banks continue to "extend and pretend" rather than restructure loans and free up capital. The exception is in multifamily where Freddie Mac, Fannie Mae and HUD have been directed to continue lending.

As a result, there are few transactions and little transparency on valuation. Given very limited financing available and poor and deteriorating operating conditions, estimated unlevered property values have declined significantly, some think 30% or more from the 2008 peak.

In the U.S.:

- Office properties are experiencing accelerating weakness with increasing vacancy and competition for tenants which forces down effective rents. Most expect vacancy rates to reach 20% over the next two years and rents to decline 15-20 % over 2009-2011. The recovery should stretch out 2-4 years beyond and cannot occur until white-collar job growth commences.
- Hotels have suffered mightily and quickly, as both business and leisure travel are down significantly. Occupancy has fallen to under 60% and revenues per average room are down 20% from their peak.
- Retail suffers from declining consumer spending and the fact that the U.S. has been "over-stored" for years. As

one analyst put it, the retailing sector is "under demolished". National retail vacancy is expected to reach a historic high approaching 20%. In this environment, the best located and most productive malls should outperform by a large margin.

- Government programs to subsidize homeownership and forestall foreclosures have hurt residential investments, which recently reached an historic high vacancy of 8% nationally. Student housing, an area in which one of our managers has a significant investment, is a bright spot in the residential arena as the largest class ever enters college over 2009-2010. Demographic trends also favor senior housing. As mentioned above, financing is available for residential properties, although at relatively low loan-to-value ratios.
- Industrial vacancy is expected to peak earlier than office, at about 15% in 2010. Industrial property owes its faster turnaround to the fact that it is more related to relatively stronger global trade conditions than white-collar employment in the U.S.

Conditions are generally better overseas, although the markdowns in appraised values are comparable to those in the U.S. In some areas, real estate pricing has turned around, at least temporarily. For example, pricing for prime office properties in London have actually moved up from their recent trough as long-term institutional investors seeking stable, long-term income look through the current poor rental markets. Asian markets are generally better off due to much better financing conditions, as their banking industries were much less affected by the credit crisis, and better economic growth both during the recent recession and into the future.

Operating conditions in real estate will not feel the full impact of the recession for a while longer, as it is a lagging indicator. Operating conditions will not enter an improving stage until job growth commences and filters through into new leases, so the worst operating statistics most likely lie ahead. However, like all markets, pricing in real estate markets looks ahead and it is likely that real estate investments made over the next 1-3 years will be among the best in well over a decade. In this regard, we like our position in commercial real estate. Our managers were successful in most cases in avoiding excessive pricing and leverage and they did a good job in selling down their investment portfolios prior to the recession. As a result, our clients have relatively small invested positions in real estate and substantial unfunded commitments in the hands of patient and accomplished managers in an environment where pricing is expected to become quite attractive.

Private Equity

As in the case of real estate, the popular indices on private equity returns remain nearly useless, but anecdotal information indicates that estimated values for existing private equity investments increased over the first half of 2009, the latest data available. Importantly, this reflects the spectacular rise in public equity markets, based on which private equity managers appraise their portfolios. On the other hand, exits remain very scarce, putting cash flow pressure on many investors saddled with, according to Credit Suisse, \$1 trillion dollars of uncalled commitments outstanding across all private equity sectors.

Within buyouts, transaction volume remains muted. However, volume is expected to increase as more highly leveraged companies default, given the \$430 billion of leveraged loans scheduled to mature between 2012-2014.

The combination of the collapse of the Internet bubble ten years ago and two ensuing recessions have devastated the venture capital business. At the height of the Internet bubble, there were 1200 active venture capital firms. Now there are 400 active firms, trending toward 300. On the plus side, some feel this dramatic reduction in the number of funds will produce a much more interesting competitive environment, reminiscent of the early 1990s. Venture capital investments initiated in those years were very productive.

Venture capital purchase valuations have also come down. For example, at the seed/early stage level, the pre-money valuation average for 2008 was \$4.2 million, compared to a range of \$5-\$9 million over the prior 15 years. The decline in exits for venture capital is even more impressive. Less than ten IPOs from venture capital funds occurred in each of 2008 and 2009, compared to a rate of 50-100 IPOs in the prior four years. The falloff in M&A deals is less dramatic. However, there is fairly widespread optimism that today's much improved equity markets will provide an uptick in IPOs and strategic buyers will use their cash holdings to acquire new technologies.

Secondary markets remain very attractive, although the pace of transactions and the discount from net asset value has fallen off from the panicked phase of late 2008 and early 2009. The pressure on investors in private equity with substantial commitments has eased as capital calls have slowed. In addition, the dramatic rise in public equity markets has raised expectations for exits and distributions in the future. Finally, it is possible that the most distressed sellers have passed through the market at this point. That said, with nearly \$1 trillion of unfunded commitments outstanding, and if the investment rate of private equity funds should pick up (meaning more capital calls), stress on limited partners could increase again.

While the current state of affairs in buyouts and venture capital could only be described as poor, we should remember that the most productive vintage years for investing in private equity have usually occurred during and just after recession years.