

## 2010 Year in Review

The biggest surprise of the year was how well asset classes performed. U.S. equity markets were up 15% and bond markets were up 6.5%, both of which are reasonably good by historical averages.

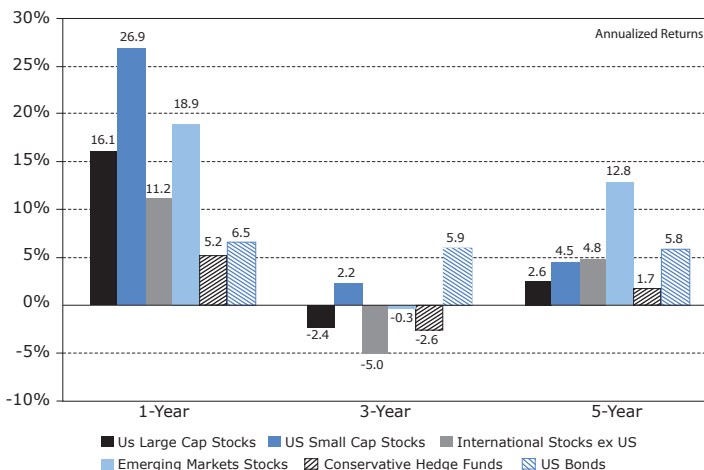
Despite highly visible concerns over sovereign and municipal credit quality, fears of a collapse in the euro and escalating drumbeats of currency and trade wars, volatility in the equity markets declined to near normal levels. Investors are becoming acclimatized to investing in a world with increased risks, which is always a dangerous sign.

Most importantly, declining volatility expectations, along with compressing risk premiums such as credit spreads, indicate that the rewards being paid to investors for taking risk have once again begun to shrink. While this does not imply we are moving into a bubble or a market unwinding is imminent, it does mean that we need to make sure we are being adequately compensated for the risks we are taking.

These seemingly normal performance numbers mask unusual dispersion and unexpected returns in many areas of the capital markets. Government bond markets were schizophrenic, with yields reaching 4% during the first quarter as the market reflected concerns about inflation and challenges faced by the U.S. government in financing massive federal deficits. Conversely, during the third quarter, the market became concerned about deflation, causing yields to decline below 2.5%. By the end of the year, yields had retraced their steps, approaching 3.5% on renewed concerns about inflation and sovereign debt.

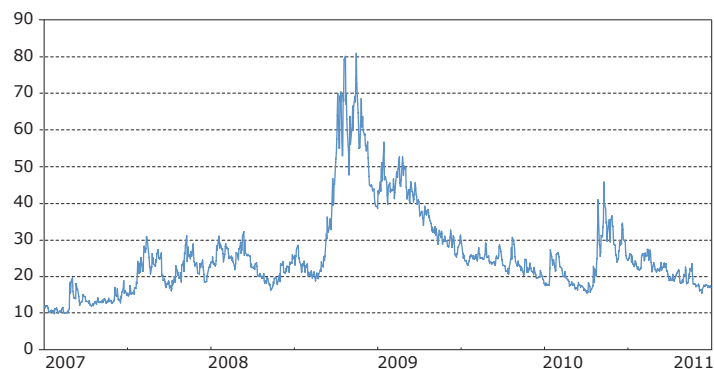
Overseas equity markets exhibited equally unexpected behavior. While Chinese economic growth is the key driver to current and future global growth, Chinese equity markets increased only 1.5%, trailing broad emerging markets indices, which increased nearly 19%. Equally surprising was that Chinese equity performance also lagged even European equity markets, which increased 4%, despite problems with massive debt burdens in their PIIGS (Portugal, Italy, Ireland, Greece and Spain). This highlights the impact of central bank policy decisions, as China was one of several countries that began an interest rate tightening cycle on concerns of accelerating inflation.

Capital Market Performance



Source: Bloomberg

VIX Index: Equity Market Volatility



Source: Bloomberg

10-Year Treasury Yields



Source: Bloomberg

## Our Long-Term Path

Several years ago, we described what we believed was a seismic shift in the world order that would lead to a gradual handoff of economic and political influence to a set of emerging countries, which previously had little say in world affairs. As we enter 2011, it is worth revisiting this transition to understand our progress along the path as well as the investment implications of our continuing journey.

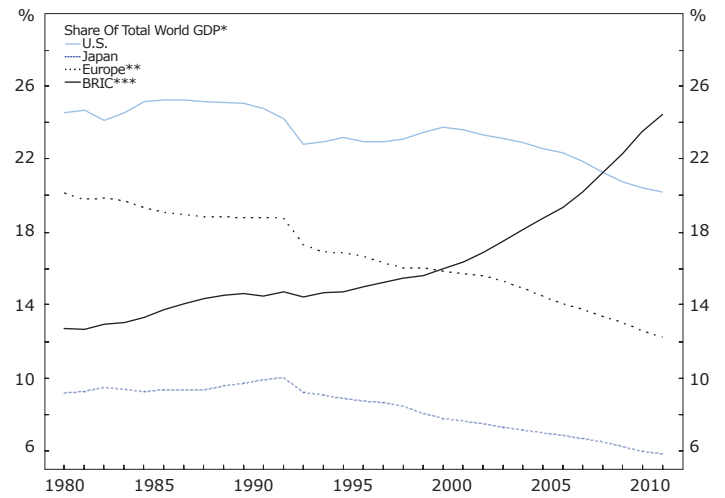
Global economic growth will no longer be dependent on the U.S., gradually shifting to a more balanced global economy with higher reliance on several emerging economies, most notably China and India.

The emergence of billions of new consumers and the resources they require will necessitate real economic change in all countries, as governments look to secure the raw materials and natural resources required to grow their economies. For example, the demand dynamics for commodities, such as copper, have been fundamentally altered by the emergence of China.

The legitimacy of every government, elected or not, depends on increasing the standard of living for its people. As countries fight to secure resources and improve local standards of living, we expect increasing government involvement in markets through direct monetary and fiscal policy, sovereign wealth funds and state supported corporate activities. These interventions represent a new form of risk, which will be difficult to anticipate and price correctly, leading to both surprise outcomes and potential investment opportunities.

While the destination may be clear, the journey will be tumultuous. These seismic adjustments rarely occur without missteps and capital markets will require adjustment. Historical precedence will mean less and the reliance on old conventions may be hazardous, causing us to question even the most basic investment concepts.

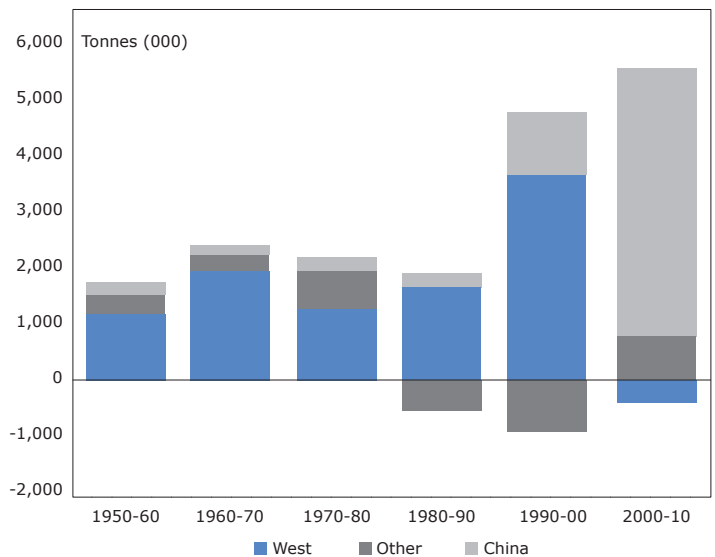
Emerging Markets Share of Global Economy



\* 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

Copper Demand Growth by Decade



Source: Macquarie Research

## Our Long-Term Path: Where are we now?

The global financial crises disproportionately affected the U.S. and developed country economies, accelerating this transition and the global economy's increasing reliance on the growth in emerging economies.

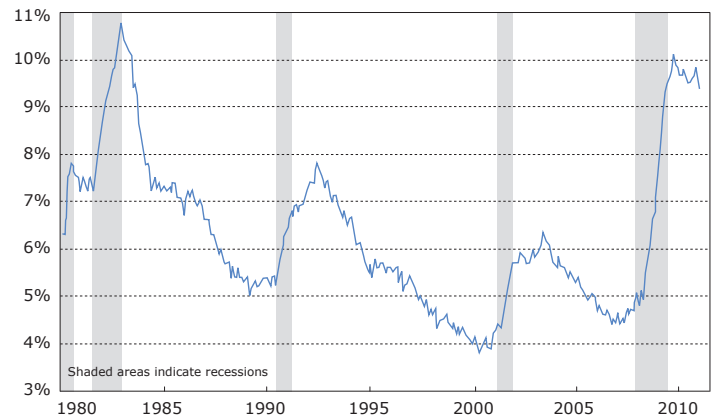
U.S. and developed market economic growth will likely remain muted despite ongoing highly stimulative fiscal and monetary policies. The old adage of "you can lead a horse to water, but you can't make him drink" describes our economic plight. Developed country governments have flooded the system with liquidity, but their economies have been stubbornly slow to react as demonstrated by structurally high levels of unemployment, which will likely not return to pre-crisis levels for a number of years.

High unemployment levels are likely to restrain income growth and spending for years, as consumers work to pay down debt through increased savings. This will be a multi-year process and will likely require that current stimulative policies remain in place to offset these economic headwinds.

Conversely, emerging economies have recovered faster and fears of economic overheating, rather than unemployment, are driving policy makers to begin tightening monetary conditions. The central banks of both China and Brazil have already begun to tighten monetary conditions and some are taking specific restrictive actions to quell developing asset bubbles in areas such as real estate.

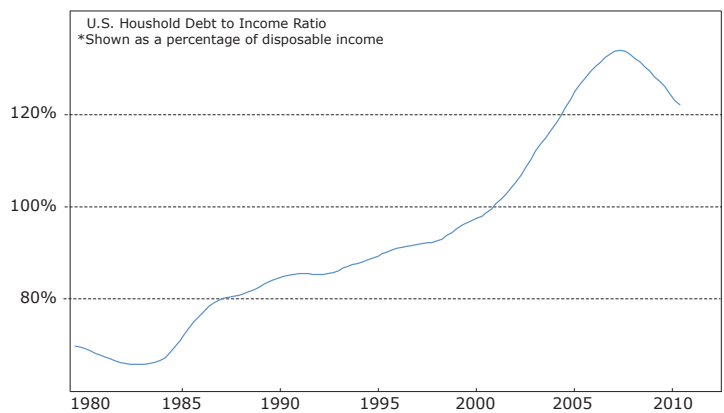
The shift of political power is equally challenging as countries form new alliances and seek new forums through which they can exert their newfound influence. Already, the traditional G7 policy group has given way to the G20 and bilateral trade agreements between emerging nations are accelerating. Reflecting these conflicting policies, trade restrictions and currency interventions are becoming the norm and governments have become active participants in markets, often with unintended consequences.

U.S. Unemployment Taking Longer To Recover Post Crisis



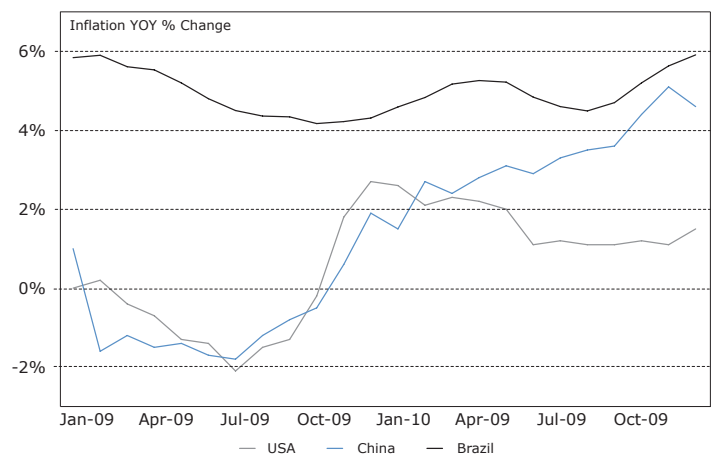
Source: St. Louis Federal Reserve

Private Sector Starting to Deleverage



Source: BCA Research © 2010

Relative Inflation Rates



Source: Bloomberg

## A Favorable Investment Environment

Capital markets remain locked in a struggle between two opposing forces. On one side, we have a very favorable environment with strong liquidity and improving private sector fundamentals. On the other side, we live in a world of global imbalances and macro fault lines on the verge of eruption, which threaten to send shock waves through the global economy and capital markets.

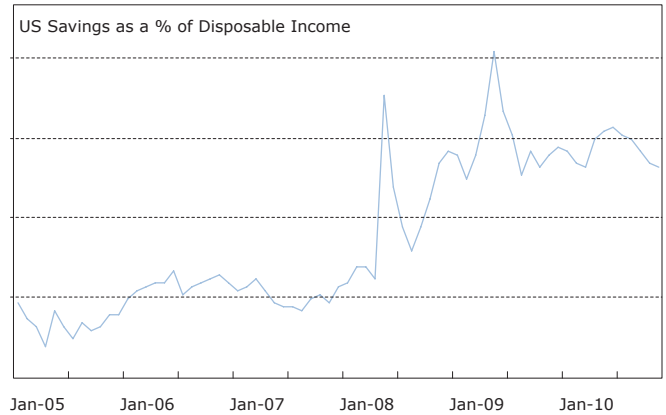
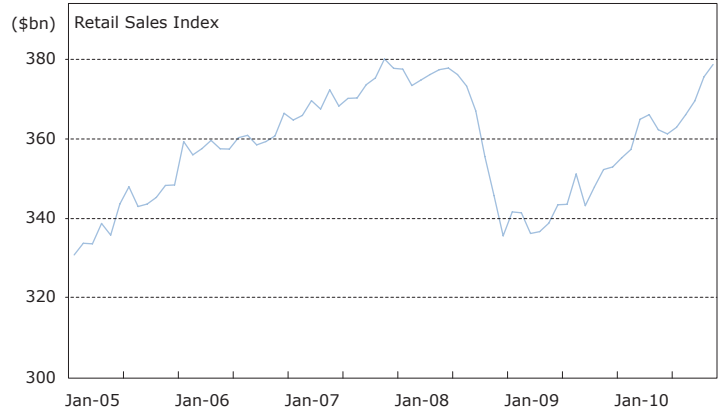
Many argue that today's investment environment exhibits the conditions that are supportive for a sustained rally. Global economic growth has returned to pre-crises levels and is less reliant on the U.S. as its primary driver. Additionally, many economists believe that the U.S. economic recovery, while slow to gain traction, will likely surprise to the positive.

Most importantly, news of the death of the U.S. consumer has been greatly exaggerated. In fact, the U.S. consumer has proven to be surprisingly resilient, as they have somehow found a way to increase savings and resume consumption, while simultaneously reducing their outstanding debt burdens.

Corporate profitability and earnings continue to surprise on the upside, even as top-line revenue growth remains modest. Relatedly, corporate balance sheets, particularly in the non-financial sector, remain very healthy with high cash balances and modest debt levels.

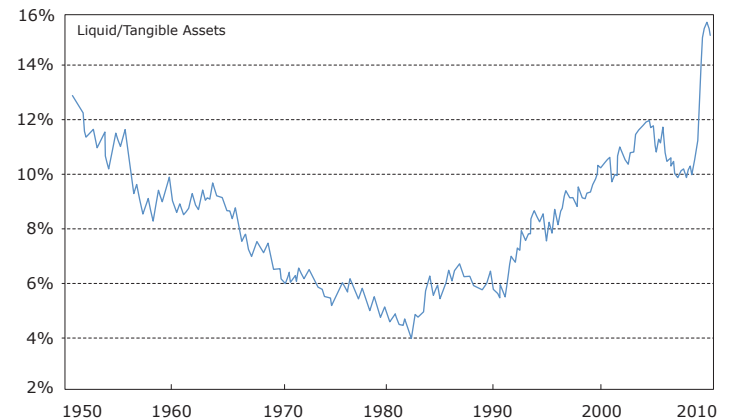
Central banks in developed nations remain in a stimulative mode, with interest rates remaining near zero and extreme policy measures, such as quantitative easing, becoming a familiar tool. Historically, highly stimulative environments have been very beneficial for capital markets and equities in particular.

### Increased Savings and Rebounding Consumption



Source: Bloomberg

### Corporate Cash Levels are High



Source: Bloomberg and Bureau of Economic Analysis

## Imbalances and Fault Lines

Before developing our investment views, we must understand the risks posed by various global fault lines present in today's unbalanced world and the implications of their potential unwinding. While many of these imbalances are interrelated, our primary concerns are the trade and economic growth imbalances between countries, sovereign and municipal debt levels, and economic policy extremes and their unintended consequences.

### Trade and Growth Imbalances

Here in the U.S., the economy has not yet fully recovered and growth has been slow to reappear despite extreme stimulus measures. However, on a global scale, economic growth has already reached pre-crisis levels, driven by a robust recovery in many emerging countries. We have long believed that global economic growth, particularly in emerging economies, would decouple from developed economies; this is now a reality, as the dispersion between high-growth and low-growth economies is reaching record levels.

Our primary concern is that growth dispersion among countries leads to vastly different economic policies, which other countries often view as nationalistic or competitive. Today, we see this in the form of currency interventions and protectionist trade activity, as politicians focus first on protecting local interests. These competitive policies may win points with the electorate in the near-term, but often result in all parties losing to some degree.

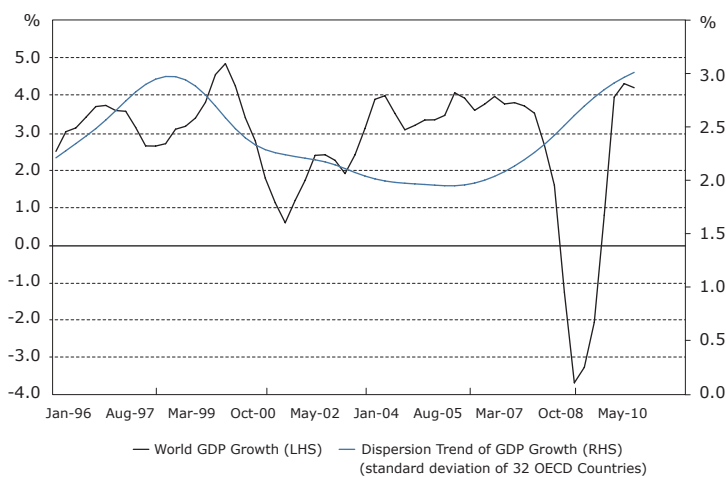
### Sovereign Debt Overhang

Many believe it is simply a matter of time before the problems in Greece, Ireland, other European countries, Japan or even the U.S. resurface, resulting in a new financial crisis. Many of these same countries face high unemployment and weak growth, increasing the probability that significant deficit spending will likely continue, only adding to the water behind the dam.

Some economists have argued that the most troubled sovereign borrowers in Europe will be unable to service their existing debt given the lack of growth prospects that these economies face. Under this scenario, debt restructuring is simply a matter of time. The key question becomes, who will pay the costs? These painful choices often lead to social unrest and discontented voters, particularly if some countries are asked to pay for the profligate ways of others.

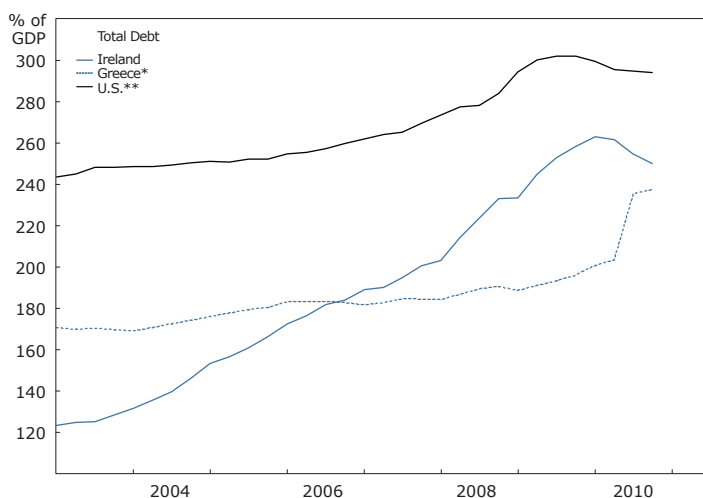
Similarly, in the U.S., we face large and growing debt burdens. Between 2007 and 2011, analysts expect the stock of publicly held debt to rise from \$5 trillion to over \$10 trillion. In other words, during these four years, we will accumulate more debt than in the entire previous history of the country!

Global Economic Growth and Dispersion



Source: GaveKal Research 2010

Total Debt as a % of GDP



\* Includes government and non-financial private sector debt. Based on OECD and ECB data.  
\*\* Includes government, non-financial business, GSEs and household debt. Based on flow of funds data.

Source: BCA Research © 2010

## Imbalances and Fault Lines (continued)

While recent U.S. elections provide some hope of fiscal prudence, the reforms required to solve these problems likely don't exist within the short-term time frame of the U.S. election cycle. In fact, recent tax law changes will worsen the deficit and debt estimations. Winston Churchill famously remarked, "You can count on Americans to do the right thing, but only after they have exhausted all the alternatives." While a crisis does not appear to be looming for the U.S., the longer these problems remain outstanding, the more difficult they will be to solve.

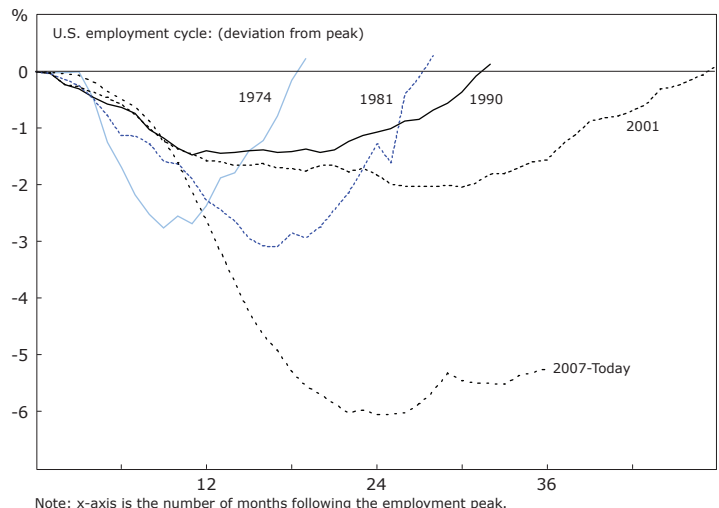
### *Economic Populism and Policy Extremes*

The legitimacy of every government is rooted in increasing the standard of living for its population. This usually means employment, economic stability and real income growth. Unfortunately, "real" solutions often require near-term pain, while the benefits accrue to the future. Accordingly, elected governments are compelled to seek short-term solutions consistent with election cycles. The electorate in developed countries is frustrated and the government increasingly distrusts markets to deliver the results they desire, at least in the timeframe they want.

For example, in the U.S. and other developed nations, unemployment is increasingly a structural problem in which each successive recession takes longer to restore employment to pre-recession levels, as the effect of globalizing labor markets takes its toll on less competitive, higher cost labor forces in developed economies. This is a structural challenge, not a cyclical problem. Over each successive cycle, the U.S. has witnessed the increasing involvement of the state into markets everywhere. Increasingly, we are witnessing rules-based standards in developed markets give way to regulatory (i.e., governmental) discretion such as the recent GM bankruptcy settlement and the new Dodd-Frank law. Relatedly, overseas, we see outright state sponsored capitalism securing strategic natural resources. For example, China is on the path to become Brazil's largest foreign investor, primarily to secure natural resources. This is leading to additional risk in capital markets, as governmental interventions are increasing in frequency and their motivations are often political rather than economic which can create unintended consequences.

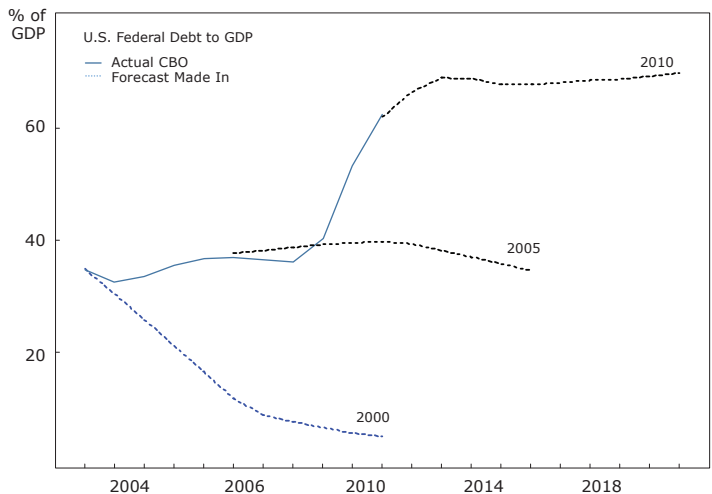
Worse yet, politically driven governments have proven to be poor allocators of resources and predictors of future events. For example, just four months after all European banks passed their recent stress tests, Irish banks required large bailouts to avoid failures. Similarly, just 10 years ago the US Congressional Budget Office projected total US government debt of a mere \$830 billion (less than 6% of GDP) by FY 2010. Actual CBO government debt figures for 2010 are over \$9 trillion. Unfortunately, government decisions have the potential for far-reaching consequences as they tend to affect large portions of the population and the economy. Paradoxically, increasing government intervention, where stability is often an objective may be among the most destabilizing forces in the world today.

Unemployment by Months Post Crisis



Source: BCA Research © 2010

Government Policies often the Result of Faulty Predictions



Source: BCA Research © 2010

## Investment Implications

Because of these fault lines, we expect to live in a world of elevated risk and face an unusually wide range of possible outcomes. As concerns about any of these factors waxes and wanes, investment markets react dramatically in both directions, creating volatile or unexpected outcomes for investors.

Unfortunately, building an excessively conservative portfolio that would protect against the eruption of these fault lines produces very bad outcomes in the more likely scenario that the global economy muddles through once again. To make matters worse, macro risks create high correlations among many traditional asset classes, which reduce the benefits of diversification in portfolio construction.

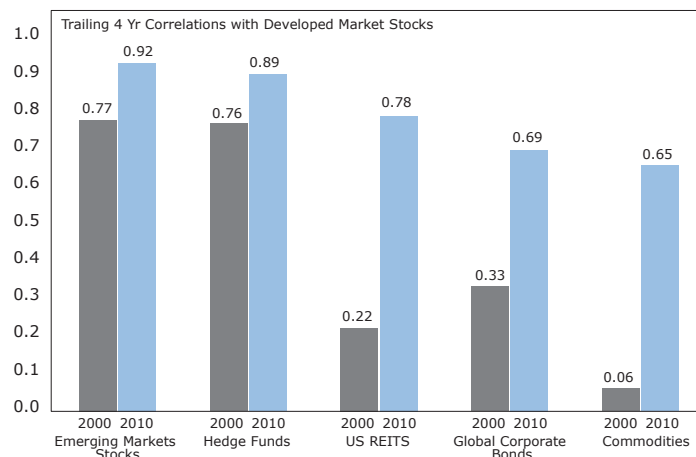
Over the last few years, we sought to protect client portfolios from extreme market events with protective investment strategies. Unfortunately, the world now recognizes many of these fault lines. As other investors sought similar protections, the cost of implementing these strategies became more expensive to the point where the medicine was becoming more harmful than the disease.

On a positive note, history has shown that widely acknowledged risks are rarely the cause of the next crisis. Capital markets are adept at acclimatizing and ignoring such risk, as shock gives way to acceptance and a tendency to “muddle through” to the next crisis. The markets’ recent yawn in the face of renewed threats of a European bank crisis in November was far less than the reaction in the spring.

So, with our risk conscious™ investment approach, how do we construct portfolios that will protect capital, through the avoidance of permanent loss of capital, yet still participate to some degree in what will likely be reasonable returns in capital markets?

We will continue to emphasize a core portfolio built around our long-term path and the tailwinds that it creates. While we should expect more volatility, a portfolio built around these powerful, secular themes can drive solid long-term performance and are likely to be more durable than betting on cyclical or timing-based strategies.

### Correlations Across Assets are Rising



Source: Bloomberg

### So what does this mean?

- Continue to build exposure cautiously to higher growth opportunities in Asia and emerging markets, both in public and private markets.
- Hire investment managers who share our risk conscious™ approach, particularly in the riskiest areas of the capital markets. Recognize that the best protection often comes from avoiding large investment mistakes and by simply buying assets at attractive prices based on sound fundamental analysis.
- Rely on managers to implement risk protection strategies when feasible, such as credit default swaps and options-based protection in an opportunistic manner.
- Avoid significant leverage, particularly in risky assets, where valuations are stretched. Leverage does not add value, but simply magnifies results.

One note of caution: Many of our macro concerns have the potential to create a melt-down in markets. However, the opposite risk, a risk of a melt-up, exists given the favorable conditions for equity markets. If this were to happen, strategies that utilize leverage and rely on the riskiest portions of the capital markets will likely do well. In this environment, risk conscious™ investors, such as Gresham and the managers we hire, will likely underperform.

## Long-Term Secular Growth Favors Emerging Markets

Our secular views and the long-term path on which we find ourselves imply that the growth in emerging markets will continue to be consistently stronger than developed economies. Over time, we believe that this growth will become self-sustaining, as an emerging middle class will drive increasing growth and consumption of goods and services over a multi-decade time frame.

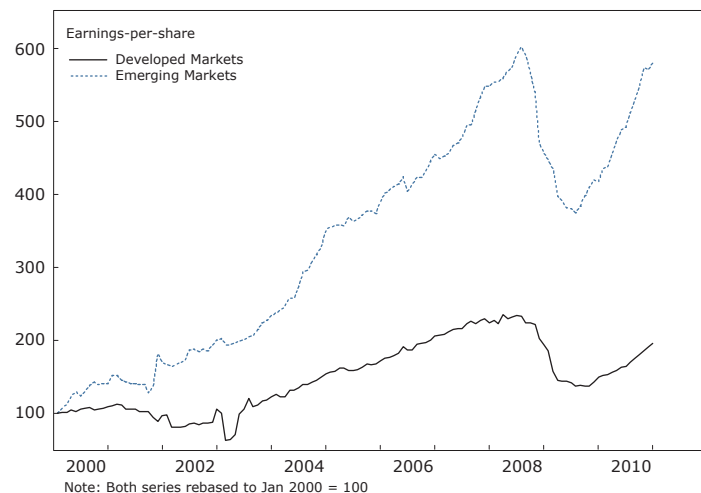
The past decade illustrates the magnitude of the emerging markets' growing influence in the economic landscape. While developed market corporate earnings have performed well by nearly doubling over the past decade, emerging market corporate earnings have tripled those of developed markets. Analysts estimate that earnings growth in emerging markets will outpace developed markets by approximately 3 percentage points annually over the next few years.

While higher earnings growth can drive strong investment returns, we must be cognizant of the price we pay. The forward price-to-earnings (P/E) ratio of emerging markets has nearly caught up to developed markets after trading at a discount for the past 15 years. However, this convergence has been the result of declining P/E ratios in the developed world. Importantly, these valuations appear to be reasonable in absolute terms and do not appear to indicate a bubble as some analysts fear.

Private equity markets provide another avenue of accessing the positive trends in emerging markets. More specifically, private investment in these markets present more attractive entry valuations and a broader opportunity set, as many more companies in the region are not yet public, particularly consumer related businesses that will benefit most from the increasing wealth of the middle class.

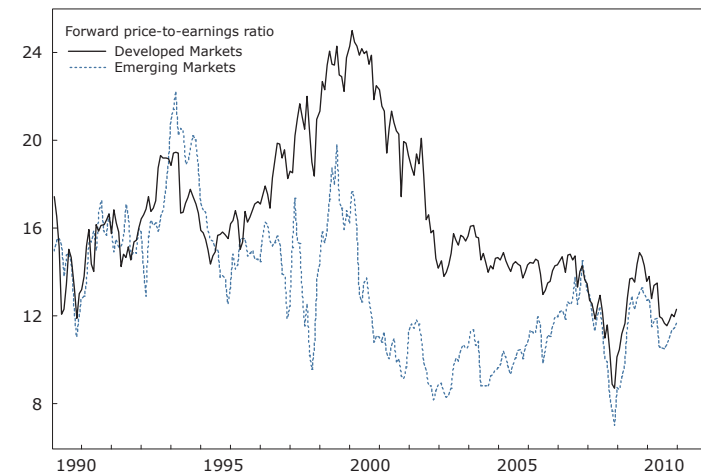
Investing in emerging markets comes with a distinct set of risks, such as monetary policy missteps, political upheaval, and corporate governance concerns. High growth markets are always more volatile, following a boom and bust cycle, as investors gravitate between exuberance and panic. Our strategy is to continue to build our exposure cautiously and with patience. We will focus on experienced managers who share our risk conscious™ approach. These managers may lag in rapidly increasing markets, but we believe will perform better over a complete cycle.

Emerging Markets vs Developed Markets Earnings



Source: BCA Research © 2010

Emerging Market and Developed Market Valuations Converge





## Distressed Debt Cycle Nearing an End

The financial crisis of 2008 provided an attractive investment opportunity in distressed debt. As credit markets stabilized, distressed debt markets were among the best performing assets, with the lowest quality debt generating the highest returns.

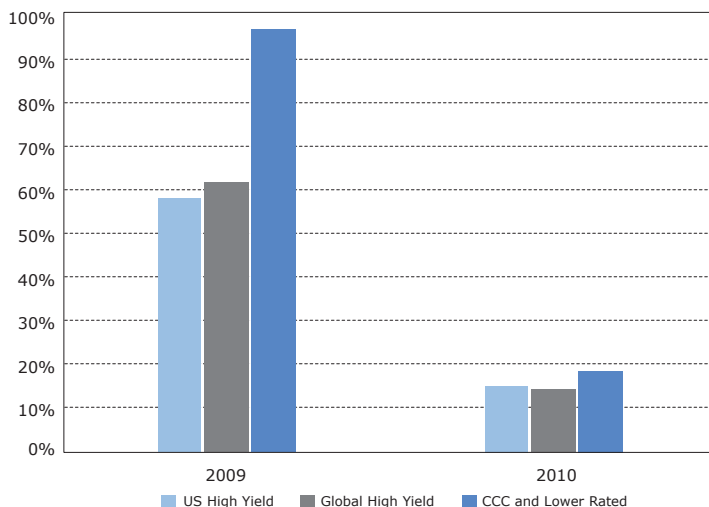
As we have progressed through the cycle, artificially low interest rates and the opening of the credit markets have allowed companies in distress to refinance and avoid bankruptcy. As a result, credit spreads on speculative debt have declined and corporate defaults have fallen dramatically.

Distressed opportunities have transitioned from a trading opportunity (i.e. capturing tightening spreads) to a restructuring opportunity. The transition will result in smaller, niche opportunities and higher risk investments such as post-reorganization equities and liquidations. These investments often involve longer investment horizons as lenders work through the restructuring process.

While the opportunity set has diminished, the restructuring phase in prior cycles has lasted for three to five years. Lenders are still working through a backlog of problem loans, as evidenced by global commercial banks recent announcements of loan disposition programs in excess of \$2 trillion, and good opportunities still exist, particularly in areas such as commercial real estate where fundamentals remain challenged.

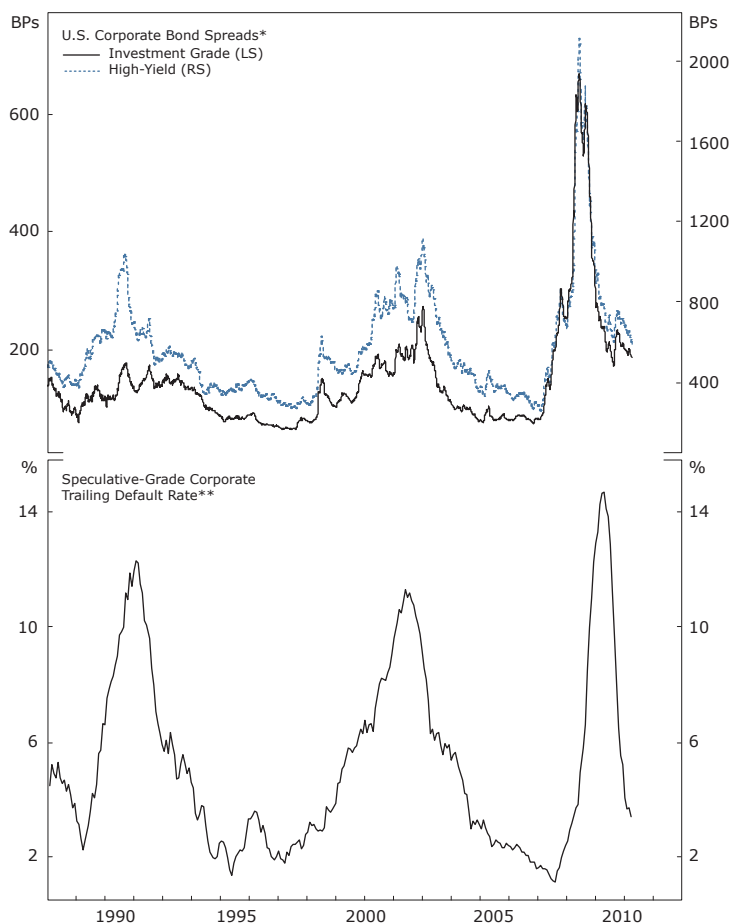
As the distressed cycle matures, Gresham's strategy is to reallocate capital out of distressed managers to higher growth opportunities in the U.S. and abroad. We will focus our remaining investments in this area on the most opportunistic managers best capable of exploiting the restructuring process.

Debt Market Returns



Source: Merrill Lynch

Corporate Spreads and Speculative Debt Defaults



\* Over Duration Equivalent Treasury Index.  
 \*\* Source: Moody's Investors Service.

Source: BCA Research © 2010

## The Changing Nature of Fixed Income Investing

The central assumption in most fixed income investments is safety of principal, in exchange for which investors have been willing to sacrifice some return. In a strategic portfolio context, high-quality fixed income provides diversification benefits and offers some measure of protection in deflationary environments.

Over the last thirty years, the opportunity cost of owning fixed income assets has been low compared to equity assets, as both expected and realized returns were not significantly different than equities. However, during this period, bond prices generally appreciated due to declining interest rates and strong credit fundamentals. The critical question facing investors is whether the balance between risk and return has now shifted?

Fixed income derives its diversification benefit and deflationary protection from sensitivity to interest rates, which is particularly prevalent in high-quality issues such as U.S. Treasuries, high-quality municipal bonds, or other high-quality sovereign debt. In contrast, corporate bonds and higher yielding assets tend to be more highly correlated to equity markets, limiting their diversification and deflation protection benefits.

Since the credit crisis, we have become increasingly concerned about the problems in the municipal credit area and growing debt levels in the U.S. and other developed countries. While we do not believe a crisis is imminent in the municipal market or that the U.S. government will experience a financing crisis like Greece or other European states, the risks of such an event are increasing. Moreover, if the U.S. were to enter a deflationary period, both municipal and federal finances would be under further pressure, as deficit spending would accelerate in an attempt to stimulate the economy. In other words, these credit concerns would increase, likely resulting in poor performance at a time when an investor needs their protection the most.

At today's low interest rates, the cost of owning these assets has increased. Additionally, the prospect of declining interest rates, which has positively contributed to the performance of fixed income investments over the last thirty years, is less likely in the future given today's already low interest rates. When we combine the potential for reduced benefit with increasing risk, we believe the risk reward relationship for fixed income assets has fundamentally changed.

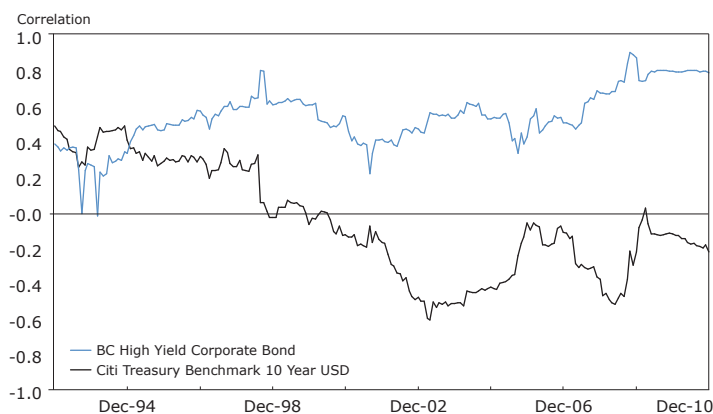
While investors can still benefit from owning these assets, we believe they no longer offer the diversification benefit or deflation protection characteristics to warrant special status and sizeable allocations in client portfolios.

10 Year Treasury Yields



Source: Bloomberg

Global Equities Correlation to High Yield Debt and Treasuries



Source: Bloomberg

# The Implications of Policy Extremes: U.S. Dollar Debasing

It is generally accepted that the Fed's all-out effort to reflate asset markets by holding interest rates at extremely low levels and employing quantitative easing measures has predictably produced the additional effect of devaluing the dollar. While we have no argument with those who believe that an orderly decline of the US dollar is a valuable tool in resolving trade and other imbalances within the global financial system, a devalued dollar reduces the purchasing power of Gresham's clients' dollar-based assets and strikes at the very heart of our primary investment goal.

Historically, a policy of easy money in which interest rates are held below GDP growth rates have produced debasement of the U.S. dollar. Coincidentally, easy money periods create cheap financing, resulting in increasing leverage and inflated asset markets as well as increased investor interest in alternate assets that act as a store of wealth, such as precious metals.

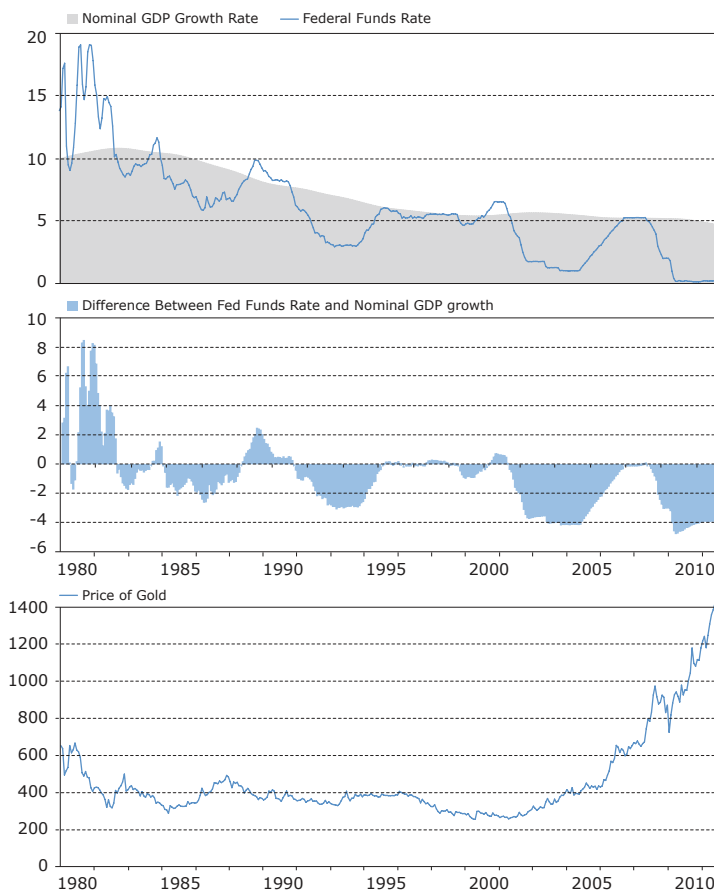
Over the last ten years, the U.S. has maintained a very loose monetary policy at the expense of slow erosion in the value of the dollar. More recently, with the extreme policy measures adopted, currency debasement has continued and prices of precious metals have increased. While we do not expect a currency crisis, we believe central banks will continue their loose money stance and the continued erosion of the U.S. dollar is likely.

The price of precious metals, while often quoted in U.S. dollars is better conceived of as an alternative currency whose price changes depend on your reference point. For example, a consumer in Australia, whose currency has been relatively strong, would view the price of gold roughly flat over the last three years. Alternatively, a consumer in Iceland, whose currency was dramatically debased, would see the price of gold as rising spectacularly. The U.S. falls somewhere in the middle of these extremes given the level of U.S. dollar debasement we have experienced.

Barring a crisis, currency debasement is a long-term, often slow-moving threat to maintaining purchasing power. Investors must also consider that in the interim, financial crises of many varieties can create a flight to safety (i.e. into the U.S. dollar) that temporarily overwhelms this slow debasement effect. Moreover, higher relative inflation rates in other nations might also change purchasing power relationships without a change in relative currency values.

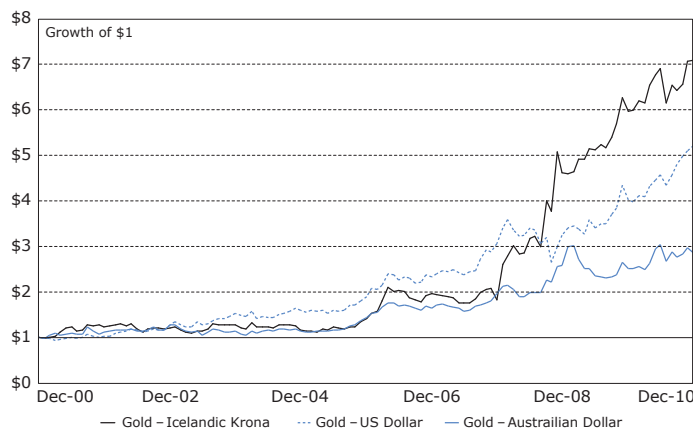
Our work with a variety of investment managers indicates that a straightforward hedge against major currencies is not effective, as other major currencies have similar long-term fiscal issues and hedging costs can be high. As there is no single, cost-effective protective strategy available, investment in a variety of assets which provide some level of protection

Artificially Low Interest Rates and Currency Debasing



Source: GaveKal Research 2010, Bloomberg

Price of Gold in Different Currencies



Source: Bloomberg

against dollar debasement is the best overall solution. Such investments include traditional assets denominated in foreign currencies and other assets likely to respond positively to a decline in the dollar, including gold.

## The Implications of Policy Extremes: Inflation

As the U.S. government prints money in an effort to support domestic growth and reduce unemployment, the rest of the world is floating in a sea of excess liquidity that is promoting inflation in fast growing developing markets. While we do not see inflation in the U.S., likely due to high unemployment and slack capacity utilization, we see inflation appearing strongly in many overseas markets.

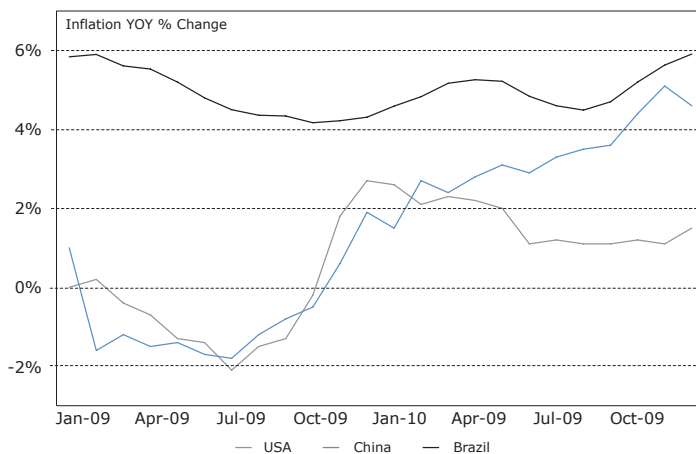
Inflation at more than a moderate level has a significant negative effect on many financial assets. Fortunately, for 25 years, investors have not needed to worry much about inflation, so why worry now? Milton Friedman famously said, "Inflation is always and everywhere a monetary phenomenon". We have had a lot of monetary expansion. However, this expansion has not resulted in inflation as bank lending has been moribund in a deleveraging trend and labor and industrial capacity have been in excess supply. This could be changing. The U.S. economy is gaining momentum and bank lending is accelerating in some segments.

Theoretically, the Fed can offset this monetary impetus by withdrawing liquidity, but this requires that the Fed anticipates a pickup in the economy, whereas they have historically adopted a "better safe than sorry" position and the Fed appears to be more politically sensitive than it has for decades. Additionally, once the seeds of inflation have been planted, it can be difficult to stop their growth as we witnessed in the late 1970s and early 1980s.

Inflation in the U.S. is likely to be an issue at some point, but history suggests that the most likely outcome is that the world "muddles through" with increased, but not disastrous, inflation levels.

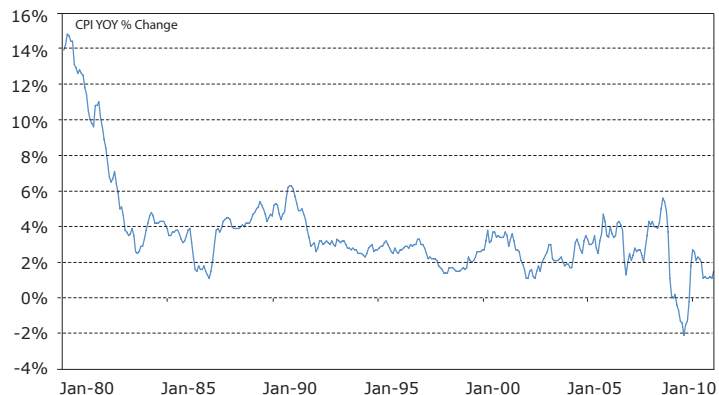
We recommend emphasizing assets that can offset inflation's erosion of purchasing power through appreciation, such as commodities and, in benign inflationary environments, equities. We also recommend a corresponding de-emphasis on assets most negatively affected by inflation, such as longer-term fixed income assets.

Relative Inflation Rates



Source: Bloomberg

U.S. Inflation Levels



Source: Bloomberg