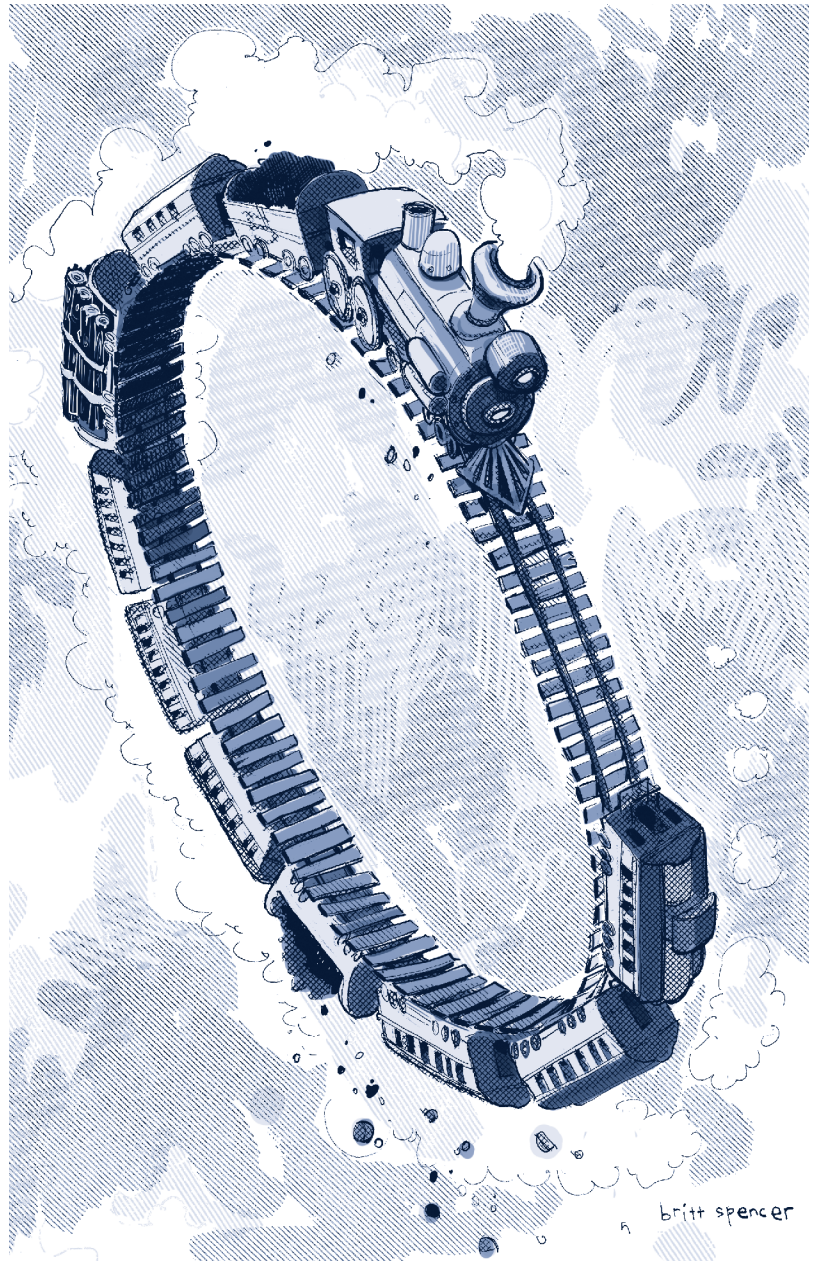


2012

Annual Outlook

Same Train, Next Station.



The world continues to ride the same train of global imbalances. While short-term solutions have allowed us to arrive at the next station, few are attempting to address the long-term issues. We believe that capital markets will continue to assail the weakest links in the financial system, which, hopefully, instills the required discipline for policymakers to make needed, but difficult, decisions. Unfortunately for long-term investors, this suggests that we will continue to encounter a series of market crises, leading to continued market volatility that can test investor resolve. During this period, it is important that investors are cognizant of the risks in their portfolios and remain alert for the opportunities created. While current markets continue to be driven by governmental policy rather than underlying fundamentals, we do see several powerful secular trends and risks that should shape the foundation of a portfolio for the long term.

2011 Capital Market Review

Global equity markets declined 7% in 2011. While U.S. markets managed to post a small gain, the rest of the world's equity markets produced disappointing results, with broad international equity markets declining nearly 14% and emerging market equities declining over 18%. Historically, equity market declines have typically coincided with periods of weak corporate performance and economic recessions. However, quite the opposite occurred this past year, as corporate profits and cash balances approached record highs, corporate default rates were near historic lows and economic activity remained positive if not robust. Positive fundamentals continue to be overshadowed by investors' concern over debt loads in the developed world, a potential banking crisis in Europe and the growing possibility of the break-up of the European Union itself. This paradox of improving fundamentals against a declining equity market was particularly prevalent in the emerging markets, which exhibited strong GDP and corporate profit growth, but also experienced the largest market declines.

Investors' reaction to bad news and subsequent policy responses created a return to the risk-on vs. risk-off invest-

ment environment we witnessed in 2008 and 2009. Unfortunately for many active managers, this created limited differentiation among stocks, as assets moved up and down together. This led many active managers to underperform markets, but had a particularly muting effect on hedge fund managers who thrive on differentiated performance among individual securities. On the year, low-volatility hedge funds lost an average of just over 3%, which, while less than the global equity market decline of 7%, was a disappointing result.

The most surprising result for the year was in fixed income. Most analysts at the beginning of last year felt that massive stimulus by many central banks around the world must lead to inflation, which would place pressure on fixed income prices. Add to that S&P's downgrade of U.S. Treasuries based on Congress' inability to put forth a credible deficit reduction plan and investors had a near perfect recipe for poor bond performance. On the contrary, Treasury bonds produced a very attractive return of 17%, as the ten-year treasury yield approached historic lows below 2%. Broader fixed income markets increased a more modest 8%, as spreads on many riskier bond assets increased, detracting from overall fixed income performance.

Table 1.

Market	Index	QTD	YTD	3 Year	5 Year
U.S. Muni Bonds	<i>Barclays Municipal Bond</i>	2.1%	10.7%	8.6%	5.2%
U.S. Treasuries	<i>Citi 10 Yr Treasury</i>	1.1%	17.0%	4.4%	8.5%
U.S. Stocks	<i>S&P 500</i>	11.8%	2.1%	14.1%	-0.2%
International Stocks	<i>MSCI EAFE</i>	3.3%	-12.2%	7.6%	-4.7%
Emerging Markets Stocks	<i>MSCI Emerging Markets</i>	4.4%	-18.4%	20.1%	2.4%
China Stocks	<i>MSCI China</i>	8.1%	-18.4%	11.5%	2.5%
Conservative Hedge Funds	<i>HFRI FOF Conservative</i>	0.1%	-3.5%	3.6%	-0.8%
Long/Short Hedge Funds	<i>HFRI Equity Hedge</i>	2.2%	-8.0%	8.2%	0.5%
Commodities	<i>Dow Jones UBS Commodity</i>	0.3%	-13.3%	6.4%	-2.1%
Gold	<i>Gold Spot Price</i>	-3.7%	5.5%	19.3%	18.7%

Similarly, the municipal bond market performed extremely well this past year despite dire predictions about a pending wave of defaults due to declining tax receipts and runaway spending levels. While many municipalities continue to struggle to balance their budgets, a lack of new issue supply overshadowed credit concerns, resulting in lower yields and good returns for investors. High quality municipal bonds generated 9% for investors, while lower quality bonds generated an even more impressive 13% return.

While valuations can be misleading, private equity investments appeared to rebound further from the recent trough in 2009, as valuations recovered driven by improving business fundamentals. Many over-levered private companies have been able to extend loan maturities and avoid, or at least delay, their day of reckoning. Emerging market private equity, particularly in China, continues to perform very well, as consumer spending growth remains robust and the IPO market remained open for most of the year, generating strong returns for investors in this area.

Real estate investors continue to experience mixed results as these markets continue their healing process. Valuations have recovered in certain areas, particularly well occupied office properties in prime locations, which have reached pre-financial crisis levels in some areas. However, the broader real estate market continues to struggle with a hangover of overly levered deals and unresolved loans which have little or no equity value remaining. We are beginning to see better investment opportunities as a result of the resolution of these situations. ■

Same Train, Next Station

So here we are once again discussing the structural problems of the world, riding the same train of structural imbalances to an unknown destination. And while short-term solutions that do not address the underlying problems may allow us to get to the next station, the risks in the global economy remain elevated, and have arguably even increased, as the imbalances continue to grow larger in the absence of more permanent solutions.

"Four years into the crisis it is surely time to accept that the underlying problem is one of solvency not liquidity – solvency of banks and solvency of countries. Of course, the provision of additional liquidity support to countries and institutions in trouble can buy valuable time. But that time will prove valuable only if it is used to tackle the underlying problem....But the underlying problems of excessive debt have not gone away. As a result, markets are now posing questions about the solvency of banks and indeed governments themselves."

—Mervyn King, Governor of the Bank of England, October 18, 2011

While Mervyn King's quote above was aimed at problems in Europe, it is applicable to most of the developed world. The western world remains in the midst of a prolonged period of deleveraging, which is creating a crisis of confidence that is forcing investors to re-examine basic assumptions about the safety of the historical underpinnings of capital markets. This can be quite

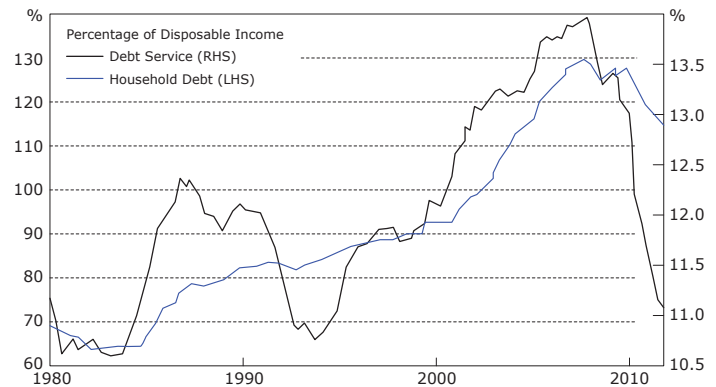
unsettling for investors and has led to an extended period of volatility and a rolling series of crises in which, as one analyst put it, the “weakest links are being picked off.” The flawed euro monetary treaty and profligate ways of the PIIGS have become an easy target for the capital markets. However, these are just the easy targets, not the only targets. The loss of confidence has begun to bleed over into other areas, as France’s bond yields have spiked up and Germany has struggled to attract investors to recent bond auctions. There are many weak links in the global economy and resolution will take some time.

The three pillars of the global economy, the U.S., Europe and China each has its own problems, much of it related to debt, demographics and a lack of economic growth in the developed world. MIT economist Rudiger Dornbusch once said that a “crisis takes a much longer time in coming than you think, and then it happens much faster than you would have thought.” While a crisis doesn’t appear to be looming on the horizon, the solutions to these problems don’t appear imminent either.

United States

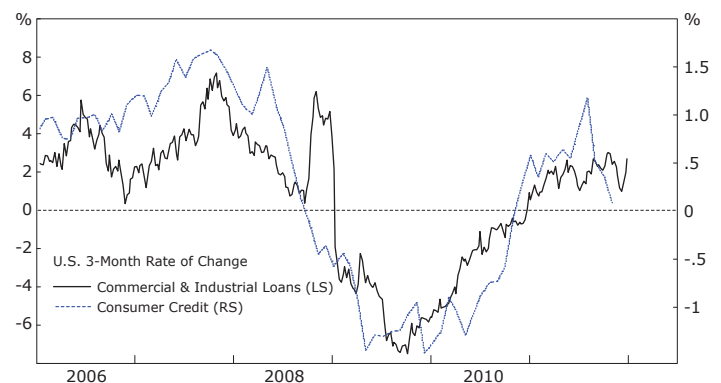
As we mentioned in our last Quarterly Review, the U.S. has been every bit as guilty of poor fiscal management as other major developed economies. However, the U.S. has (so far) dodged the capital markets’ wrath through a heroic combination of fiscal stimulus and an artificial lowering of interest rates by massive Federal Reserve purchases of Treasuries and mortgage debt. A flight to safety has benefitted the dollar and Treasury securities, which has resulted in interest rates that remain near record lows. Unfortunately, this is a result of fear and risk aversion rather than confidence in future fiscal responsibility.

Chart 2. Aided by Low Interest Rates, U.S. Households Continue to Deleverage



Source: Federal Reserve, Bureau of Economic Analysis

Chart 3. Growth in Consumer Credit and Commercial Loans

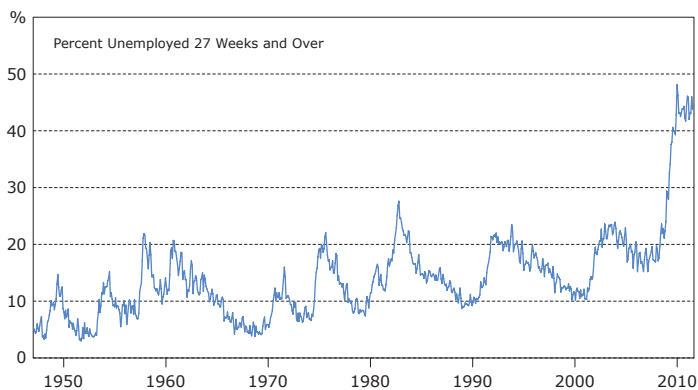


Source: BCA Research 2011

The largest structural challenge is that the U.S. has a debt and deficit profile that is simply unsustainable. U.S. gross debt to GDP passed 100% for only the second time in history. The last time this happened, the U.S. was fighting a two front war and preparing a land invasion of Japan. Unfortunately, almost all government revenues are spoken for through mandatory programs and interest expense. All Congress can do is fight over scraps.

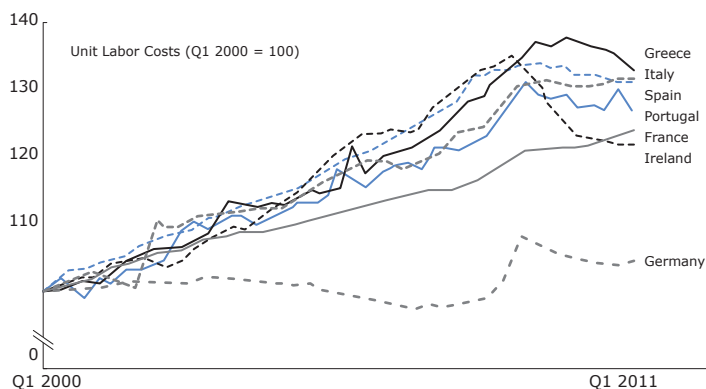
The good news is that artificially low interest rates have allowed U.S. households

Chart 4. Unemployment is a Structural, Not Cyclical, Problem



Source: St. Louis Federal Reserve, U.S. Dept. of Labor: Bureau of Labor Statistics

Chart 5. Competitiveness of Many European Countries



Source: OECD

to progress through their deleveraging process with some amount of reduced pain. **Chart 2** shows both household debt and debt service to disposable income. It is clear that U.S. households have a ways to go in reducing debt obligations to more normal levels. However, record low interest rates have mitigated the financial burden these debts are placing on households to a level that is equivalent to what the country experienced nearly two decades ago.

Some argue that the post-crisis U.S. economy doesn't appear to be all that bad, as

we continued to see modest, positive surprises in several economic reports over the last few months. For example, as shown in **Chart 3**, growth in consumer credit and commercial loans remains positive. Unfortunately, many analysts feel these positive reports may be a bit of a mirage. After all, how much can consumer spending rise when unemployment remains high and disposable income has begun to decline once again? Worse yet, most analysts believe that reported unemployment numbers significantly understate the labor problems in the U.S., as many have simply given up looking for a new job and are no longer counted in the official statistics. **Chart 4** shows the unusually long period workers remain unemployed indicating the unemployment is a structural problem that will take a long time to cure. As a result, the U.S. can expect to remain in a slow growth mode, which will make it even harder to reduce our overall debt burdens.

Europe

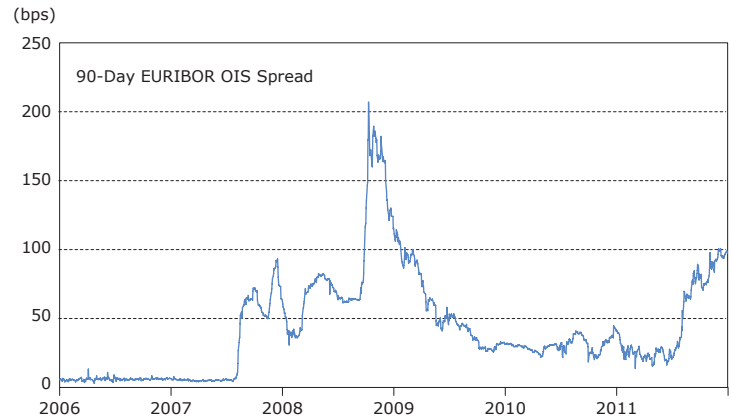
For some analysts, it is now not a question of whether the euro zone will break up, but one of how and when it will break up. Without economic growth, many of the peripheral countries won't be able to make the economic and social adjustments required to avoid leaving the current treaty. Even the original architects of the euro now concede that the concept was flawed from the start. Without a flexible exchange rate mechanism to rebalance the competitiveness of labor and capital, the adjustments must occur in real terms, which is very difficult given the European social compacts. As a result, European countries have developed significant disparities in growth, industrial production and unit labor costs. **Chart 5** shows the unit labor costs of various European countries since the creation of the common currency. Only German

labor has managed to remain competitive throughout this period.

Now, as a result of the recent European Summit, these countries are caught between German-led austerity mandates and the inflexibility of the rigid common currency agreement. Their economies are becoming even less competitive every day and will eventually require internal adjustments, such as falling wage rates, adding further stress to the fragile social fabric of these countries. This adjustment process, should it occur within the current framework of the euro, will be long and painful. Growth will suffer, applying further pressure to already precarious state finances. Many countries begin this adjustment process with limited flexibility due to their already high debt burdens. Gross debt to GDP for these countries has steadily increased during the last decade, reaching levels that have created doubts about the very solvency of these countries.

Making matters worse, analysts estimate that European banks have roughly \$650 billion of exposure to these PIIGS, which far exceeds the equity available to cover defaults or even modest impairment of these assets. Unlike the U.S., the assets of the banks of Europe far exceed the GDP and resources of their home countries, making the task of their rescue quite formidable should it be required. As a result, the confidence of euro banks' trust in each other has begun to erode. **Chart 6** shows the EUROBOR-OIS spread, a measure of interbank confidence, has started to increase once again, something we last witnessed during the 2008 financial crisis. Additionally, the general public appears to be losing confidence in the banking system. As one analyst put it, "Who really needs to keep their deposits in a European bank? What Greek in his right mind would keep his

Chart 6. Confidence in European Banks in Decline



Source: Bloomberg

money in Greece?" It has not been headline news, but there has been a slow run on the European banks that both the U.S. Federal Reserve and the ECB have attempted to replace with lending agreements.

The December EU summit agreement appears to have calmed capital markets for the moment, but most analysts agree that the long-term problems remain. This agreement does not address a cohesive growth strategy, the creation of a true fiscal union or the competitive disparities within the EU. Worse yet, with the UK failing to join the agreement, the agreement itself cannot be implemented within the EU framework. At this point, predicting the future for the euro zone is nearly impossible, even for the most accomplished political economists. The road to stability and the resolution of these imbalances will be long and subject to repeated relapse. As in any democracy, crisis will continue to be a necessary factor in forcing governments and the general electorate to accept painful choices.

Asia and China

We continue to believe that China and other emerging nations will be significant beneficiaries of a shift of economic and political influence over the coming decades. Billions of consumers are emerging from poverty, as these societies and their economies catch-up with the economic modernization and improved standards of living already in existence in most western nations. However, a transformation of this magnitude rarely happens without significant disruptions.

China and other emerging nations share the western problems of high debt levels as a percentage of GDP. However, most analysts believe that the significantly higher economic growth rate of these countries mitigates this problem, as the obligations shrink rapidly as a percentage of GDP over time. Many believe that China's growth rate will decline, but this should be put into context. Most expect real growth rates to decline from averaging roughly 10% per annum to something closer to 8% per annum; still a very healthy rate of growth.

At the moment our primary concerns about China center on three potential concerns: 1) negative feedback loops from slowing economic growth in Europe, China's largest export market, 2) the stress on the European banking systems and 3) the rollover in the Chinese property markets, which have been a central element of China's growth story.

Despite its status as the world's second largest economy, China has an underdeveloped banking system that is particularly deficient in funding small and medium sized enterprises, the backbone of the Chinese economy. Additionally, much of the growth in Asia has been funded by over-

sized European banks, which are in the midst of a solvency crisis. Disruptions to the European banking system could further hamper growth in the Chinese economy.

During the financial crisis, China was the most aggressive in its pursuit of stimulus measures. While their efforts were very successful in ensuring that China's growth path continued, they exacerbated inflationary pressures, particularly in food and real estate prices. So while the rest of the world remained in an accommodative mode, the

Despite its status as the world's second largest economy, China has an underdeveloped banking system that is particularly deficient in funding small and medium sized enterprises, the backbone of the Chinese economy. Additionally, much of the growth in Asia has been funded by oversized European banks, which are in the midst of a solvency crisis. Disruptions to the European banking system could further hamper growth in the Chinese economy.

Chinese government began an aggressive tightening cycle to address inflationary concerns. Once again, it appears their efforts have been successful, as Chinese real estate prices have begun a much needed retracement process and inflation appears to be coming under control. The primary risk facing investors, given the importance of real estate in the Chinese economy, is determining if this pendulum swung too far. In the last few months, we have begun to see signs of easing once again, including the reduction of reserve requirements for the banking system.

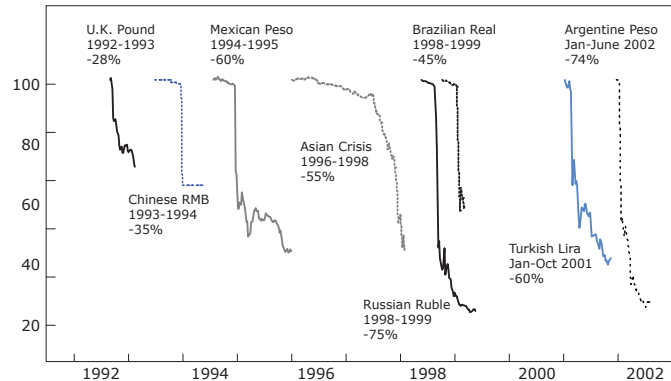
Policy Responses and Capital Market Implications

The current investment environment is fundamentally different than that which investors faced over the prior 30 years. For example, in areas such as sovereign debt, some of which once were considered cornerstones of portfolio construction have become significantly less attractive to the point where some have described them as return-free risk. Such structural changes happen periodically and have a significant effect on long-term asset class returns. We are in the midst of two such structural changes; first, the unwinding excessive debt accumulated over decades in the developed world and the fallout from the global financial crisis and, second, the rise of the BRIC nations, particularly China.

The preferred method of exiting a debt crisis is through a sustained period of high growth, but this is unlikely given what we know about the history of such circumstances and the potential growth rates in developed economies. Examples of post-war debt-laden, crisis-stricken countries that were able to grow their way out of trouble are rare or arguably non-existent. The only practical solutions have been to default on their obligations or to debase their currencies, similarly reducing the real value of their outstanding obligations. **Chart 7** shows the history of such debasements and restructurings since the early 1990s. This strategy was effective, as in all cases these economies were able to begin their growth path again.

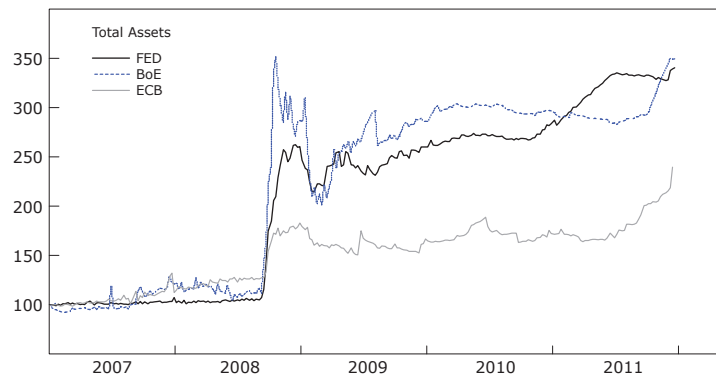
While debt restructuring and default is a possibility, it will likely be used as a last resort. On the other hand, a sustained policy of artificially low real interest rates has the effect of debasing the home currency. This policy has been underway in most

Chart 7. A History of Currency Debasement



Source: BCA Research 2011

Chart 8. Massive Balance Sheet Expansion



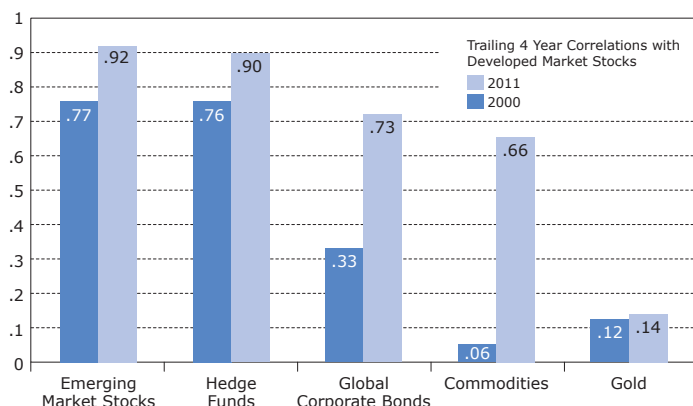
Note: Rebased to 100

Source: BCA Research 2011

developed countries for some time. In some countries such as the U.S., real interest rates are already negative and other monetary policies have been implemented, primarily through the use of quantitative easing or central banks purchasing debt securities to further lower interest rates.

Chart 8 shows the massive balance sheet expansion by the U.S. Federal Reserve and the Bank of England and more recently the European Central Bank. We expect these policies of "loose money" to continue for

Chart 9. Increased Correlation Across Asset Classes Reduces Effectiveness of Diversification



Source: Bloomberg

some time, as the developed world works out from under their debt burdens.

China's emergence has fundamentally altered the global economic landscape. Over the past two decades, China's (and India's) integration into the global labor force created a long period of disinflation, as businesses shifted to the lower cost production available in these markets. However, this period is coming to an end, as a combination of increasing wages and appreciating currency are driving up costs. Today, China is no longer creating a disinflationary influence, but is beginning to foster the opposite effect. For example, China has become the largest or second largest consumer of most industrial commodities, creating additional demand and potentially higher prices in some markets. Additionally, per capita income continues to rise and discretionary spending is leading to increased demand across a range of goods and services. These factors all contribute to the potential for higher inflation in the future.

Capital Market Implications

At the risk of sounding like a broken record, we expect capital markets to remain volatile over the coming years, as the structural adjustments required to navigate these changes are often difficult. Additionally, the difficult decision to make such adjustments, particularly in democracies, is often deferred until a crisis necessitates action. This suggests a rolling series of crises in the developed world that will lead to elevated volatility and the potential for periodic, significant market declines. It is therefore important to consider the risk in an investment portfolio to ensure both the investor and the portfolio can withstand the variability caused by market movements without permanent loss of capital arising from forced selling at any point in the cycle.

As investors attempt to deal with high volatility levels, the effectiveness of one traditional tool, diversification, has been significantly reduced. As shown in **Chart 9**, correlation across a wide range of asset classes and securities has increased, thereby reducing the effectiveness of a diversified portfolio in reducing volatility to investors. Over the last decade, as interventionist policies and macro level risks have increased, the relative importance of individual security and asset class characteristics have been diminished. Increasingly, investors tend to react indiscriminately, buying or selling risky assets together in response to the changing perception of macro level risks. Understanding the risks and drivers of return are more important today than ever before to maximize whatever diversification benefit remains in global capital markets.

It is important to reinforce the difference between a country and a company. So

much of our investment discourse these days is focused on macro level concerns regarding structural imbalances in the world. While this has a strong influence on capital market environments, corporations are independent entities and have demonstrated an ability to adapt faster than governments. While governments have struggled to address the new reality, corporations have been quite adept at shifting their cost structure and capital investment and, hence, the driver of their profitability to overseas markets as shown in **Chart 10**. So, while things may seem dour for some governments and economies, investment opportunities exist and can even be plentiful in the most difficult of times.

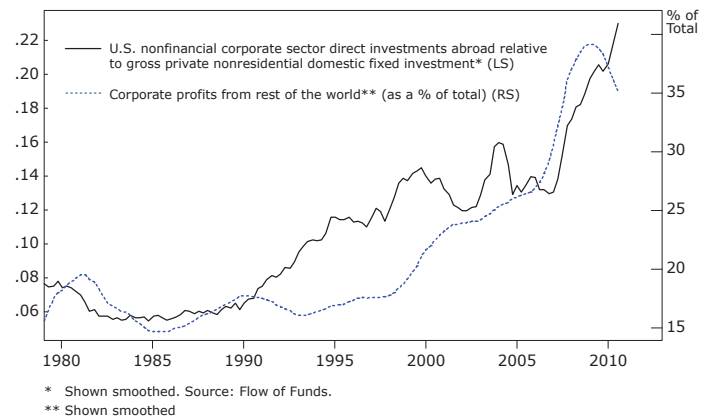
Investment Themes and Portfolio Construction

Secular vs. Cyclical Opportunities

During this period of volatility, powerful secular trends continue to move forward. While capital markets may not recognize the underlying fundamentals at any given time, building positions that can capture these trends is an important driver of long-term performance. For example, the strongest combination of GDP and consumer growth in 2011 occurred in the emerging markets, but due to the risk averse nature of investors during the year, these markets declined the most.

Conversely, disruption in capital markets can also present compelling opportunities to invest. Whereas our current investment focus is on secular themes, our focus in 2008 and 2009 was on the cyclical opportunities presented by the financial crisis, such as distressed debt investments. While we have limited exposure to these more opportunistic investments at the moment,

Chart 10. Corporations Move Capital Investment Overseas

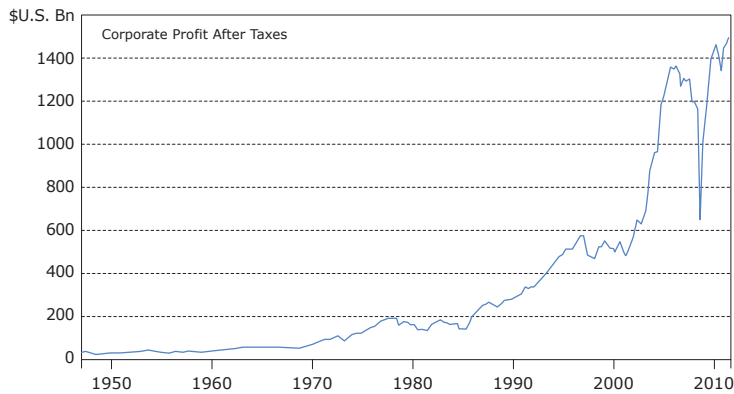


Source: BCA Research 2011

the current environment has the potential to produce such opportunities again. Our primary investment themes include:

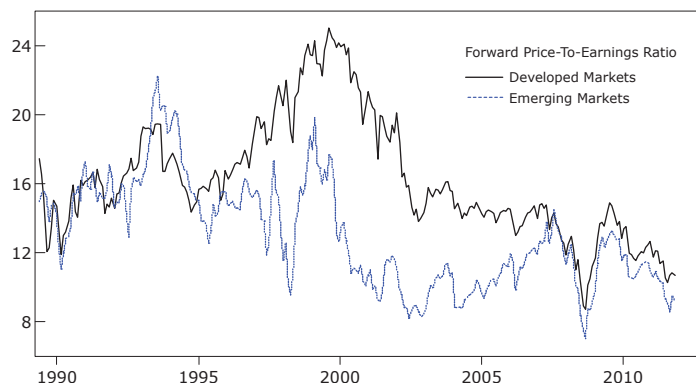
- Continue to increase our exposure to emerging market equities in order to capture the strong growth potential from the emerging consumer, particularly in China. As we describe in more detail below, the implementation of this investment idea has taken some non-traditional forms, as we are concerned with the volatility of these markets and the under-representation in the public markets of the sectors that we feel will best capture these powerful secular trends.
- The risk reward relationship of many fixed income investments has been fundamentally altered by artificially low interest rates. Despite recent good performance, we continue to believe that investment in these areas should be minimized due to our concerns about the long-term performance of these assets. We believe that some position in the

Chart 11. Corporations' Profit Recovery Has Been Remarkable



Source: St. Louis Federal Reserve

Chart 12. Equity Valuations are at Relatively Low Levels



Source: BCA Research 2011

profit margins are at record highs and balance sheets are very healthy. In a world of government interventions and uncertainty, the most enduring, stable assets might simply be those of high quality global corporations. While attractive valuation is an elusive idea with so many unresolved issues remaining in the world, enduring corporate value may be a relative safe-haven in a world of sovereign uncertainty.

- The regime of loose monetary policy is well established as evidenced by negative real interest rates and quantitative easing initiatives by central banks. We believe this will continue to debase fiat currencies. Real assets, such as gold and other precious metals, can help protect the long-term purchasing power of a portfolio. From a portfolio construction perspective, gold, like fixed income, is uncorrelated to equity returns, providing some diversification benefit as well.
- While we see no immediate threat of inflation arising from the global loose money policies of central banks, we are mindful that the amount of money in the system will eventually likely lead to inflation at some point in the future.

asset class is still appropriate for conservative investors, as high quality fixed income is still one of the few remaining assets that provides some diversification benefit in a world of high correlation among assets. Additionally, the asset class will provide some protection in the unlikely, but not impossible, scenario of a global deflationary environment.

- Corporations have been able to navigate the global imbalances and volatility relatively well. Today, profits and

Equity Valuations

The tension between increasingly attractive valuations and persistent macro risks makes evaluating the relative attractiveness of equities a difficult task. Corporate profit recovery and growth has been quite remarkable in the face of global uncertainty as shown in **Chart 11**. This strong performance has not been reflected in equity markets. **Chart 12** shows that the price-to-earnings ratio of developed market stocks is currently the most attractive

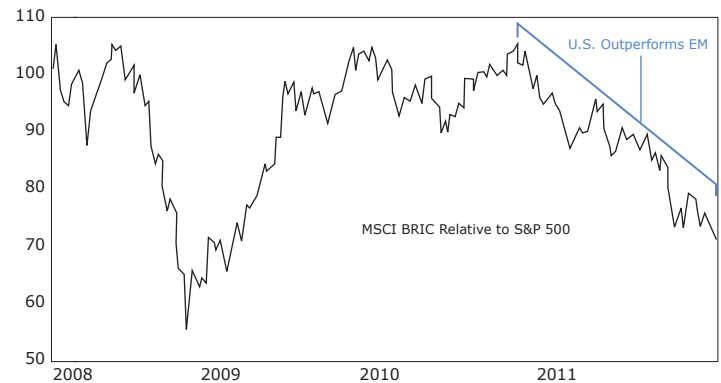
they have been in over 25 years, with the exception of the 2008 crisis period. On the other hand, it is difficult to build a case for multiple expansion until the current imbalances and financial system risks are reduced. Additionally, some analysts argue that while corporate profits are at record levels, these profits are built on a limited recovery in labor markets and corresponding labor expenses. How much should an investor be willing to pay for this kind of profitability? While equity investments are likely to remain volatile, investors should consider increasing their allocation to high quality equities.

Emerging Markets and China

For several years we have looked for ways to increase our exposure to the powerful secular growth trends in emerging markets. Over the past twelve months, emerging markets have underperformed developed markets by a wide margin, declining over 18% compared with a positive return for U.S. stocks as shown in **Chart 13**. Additionally, the declines in these markets during the depth of the financial crisis in 2008 were nearly twice as large as U.S. markets. So why do we want this exposure in our portfolios?

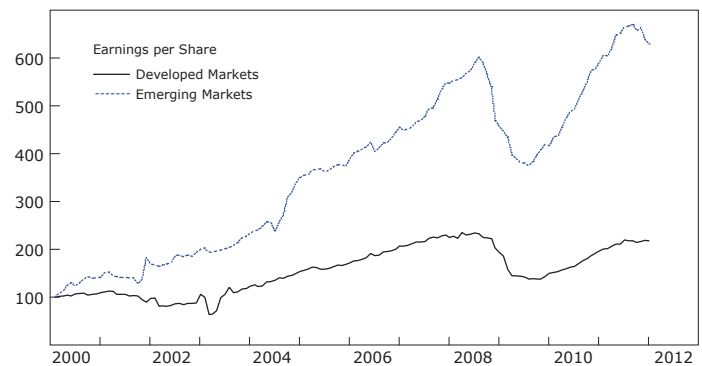
Let's start with the easy part of the question, which are the reasons we find these markets attractive. First, these markets offer compelling growth potential. With the U.S. facing growth headwinds and Europe likely sliding back into a recession, the long-term growth rates these countries offer, 10% to 15% in nominal terms and 6% to 8% in real terms, are quite attractive. However, higher growth markets do not always translate to better equity market performance. More important is how these high economic growth rates translate to corpo-

Chart 13. Emerging Markets have Fared Much Worse than Developed



Source: Bloomberg

Chart 14. Emerging Markets EPS have Grown More Rapidly than Developed



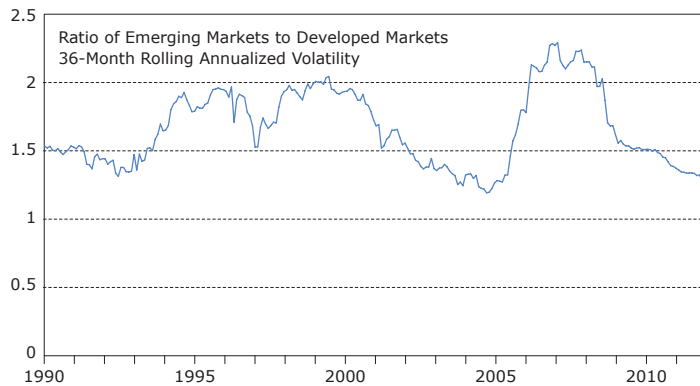
Note: Both Series Rebased to Jan 2000 = 100

Source: BCA Research 2011

rate profit growth rates and the valuations investors must pay to own these securities. Currently, both of these considerations further bolster the case for emerging markets.

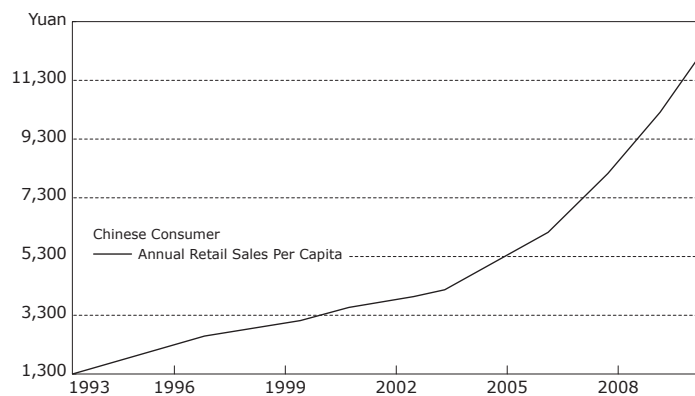
Since 2000, emerging market earnings-per-share ("EPS") have grown over six fold compared with the relatively modest doubling of comparable measures in the developed markets over this same period as shown in **Chart 14**. Importantly, we expect this superior EPS growth to continue well

Chart 15. Volatile Emerging Equity Markets Require a Risk Conscious® Approach



Source: Bloomberg, MSCI

Chart 16. Emerging Consumer Class Will Drive Growth



Source: International Monetary Fund, China State Statistical Bureau, China National Bureau of Statistics

into the future. Similarly, the valuation of emerging market stocks is also compelling. **Chart 12**, referenced earlier, shows that emerging market equities have become quite attractive, trading for roughly 9 times forward earnings, which is approaching the lowest level in 25 years. On a relative basis, a compelling gap to developed market valuations has once again opened despite the higher growth rates available in emerging markets.

While these are compelling attributes, investing in these markets is more challenging than most realize. First, public markets are quite volatile. Over the past thirty years, volatility levels in emerging markets have consistently been 1.5x to 2.0x higher than in developed markets, as shown in **Chart 15**. We have witnessed secondary effects, where this volatility is accompanied by rapid investor withdrawals, causing significant disruption to a manager's business. Our implementation in public markets has focused on managers who have explicit methods to manage this volatility, which provided significant benefits during the declines in 2011.

Compounding the risk of higher volatility is the fact that the correlation of these markets to developed markets has increased over the last few years, as markets and economies have generally become more interconnected. While emerging market investments can provide diversifying exposure to a range of other currencies, the stocks in these markets have become highly correlated to developed markets. We no longer believe this investment provides significant diversification benefit to an investor's portfolio. More specifically, investments in emerging market equity should be viewed as more of a substitute for, rather than a complement to, existing equity investments and evaluated in an appropriately relative context.

While many emerging markets investors focus on the higher growth rates available in these markets, the real enduring and compelling trend is narrower; the emergence of a middle class that will drive growth in domestic consumption for many years to come, as shown in **Chart 16**. While this is a well known economic fact, investors often miss the fact that publicly-listed consumer stocks account for a

Chart 17. Relative Underweight to Consumer Sector Stocks in Emerging Market Stock Exchanges

	U.S.	Brazil	India	Russia	China
Consumer	23.3%	17.4%	15.6%	1.7%	12.4%
Energy & Utilities	15.9%	22.4%	17.7%	61.3%	29.4%
Financial	14.6%	29.5%	24.3%	17.2%	21.2%
Healthcare	11.2%	0.6%	3.0%	0.0%	2.7%
Industrial	12.0%	3.6%	11.2%	0.0%	14.7%
Information Technology	16.9%	0.0%	17.7%	0.0%	1.3%
Materials	3.1%	23.2%	7.2%	14.9%	17.0%
Telecom	3.0%	3.4%	3.3%	4.9%	1.3%

Source: Bloomberg

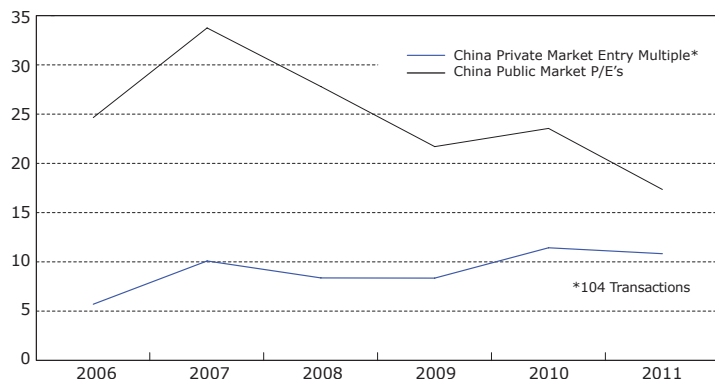
remarkably small percentage of emerging market exposure, as shown in **Chart 17**. For example, consumer stocks account for 12.4% of the public companies listed on the Shanghai Exchange in China. Other sectors that tend to represent the consumer, such as healthcare and technology, are similarly underrepresented in these markets. This is not unusual for the early stages of market development, as the large state-sponsored or state-owned companies tend to develop faster and list earlier. These companies are typically in the energy, utilities, financial and materials sectors, which in China collectively account for over 80% of market capitalization. Worse yet, these companies tend to have inferior management and exhibit slower growth characteristics – the very things investors in these markets are not seeking.

Investors who want exposure to the public markets should seek a larger exposure to these sectors than index-based or traditional actively managed strategies capture. We

have long viewed the private markets as an even better alternative, as the rapidly growing consumer companies tend to be smaller and typically have not yet listed on an exchange. In addition to gaining exposure to the fast growing sectors of the economy, these companies have historically had the additional advantage of more attractive valuations. **Chart 18** shows the entry valuation of selected private equity transactions over the last six years compared with public market valuations.

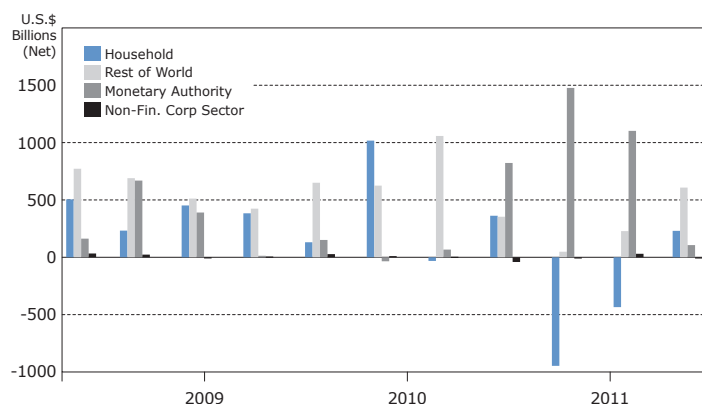
With recent headlines on a small number of Chinese “frauds,” we would be remiss to not address governance in the markets. While the emerging markets have had their share of frauds, we generally view governance practices, including transparency, financial controls and reporting standards, as continuing to improve. Our investment experience in these markets has been quite positive in this regard, but we and the managers we hire remain vigilant.

Chart 18. Private Equity Valuations Have Been More Compelling than Public Markets



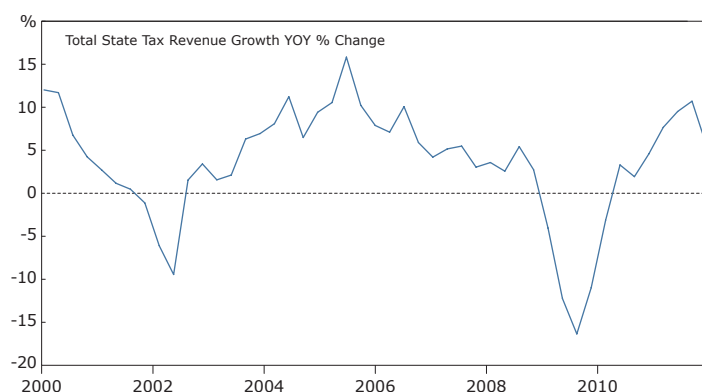
Source: Asia Alternatives

Chart 19. Who is Buying U.S. Treasuries?



Source: Federal Reserve Flow of Funds Report

Chart 20. An Increase in State Tax Revenue has Provided Some Relief



Source: U.S. Census

Fixed Income Markets

High-quality government bonds may be the one true bubble in the world today. While this sounds like a statement with dire consequences, the current low growth environment and investors' continuing view of the U.S. as a safe haven, have allowed artificially low bond yields to persist. With the Federal Reserve still pushing a near zero percent target for short term rates and massive market intervention keeping ten year bond yields below 2%, the only way for long-term investors to make money is to hope for a Japan-like outcome with no real growth and continuing deflationary pressure. As one analyst put it, "Unfortunately, that scenario is not out of the question."

To get a sense of the distortions in the Treasury market, an examination of the Federal Reserve flow of funds data is illuminating. **Chart 19** shows purchases by various market participants. The private sector (households and non-financial corporations) have been virtually eliminated from the market by artificially low yields and replaced by the Federal Reserve. Clearly, this is a badly distorted market whose prices are not being set by a natural equilibrium of supply and demand.

Municipal bonds performed similarly well. While Meredith Whitney gained notoriety for her dire predictions about the pending crises in municipal credit, the markets proved to be one of the better performing asset classes around the globe in 2011. In fact, as shown in **Chart 20**, total state tax revenue has once again turned positive, providing some relief for municipal finances. However, the budget imbalances and debt burdens have not disappeared and we believe that many municipalities will continue to suffer financial stress, leading to

increasing downgrades and defaults. Still, a broad crisis centered in municipal finances is unlikely.

It may be a long time before the fixed income bubble bursts and, hopefully, these market distortions are eliminated without being precipitated by a crisis. However, we feel that at current yield levels, the risk-reward proposition for investors is unappealing. We continue to recommend reducing fixed income allocations to a minimum threshold level and maintaining a high-quality orientation. The strong performance of the asset class in 2011 gives investors a good opportunity to shift allocations in this direction if they have not already done so.

Concluding Thoughts

As mentioned earlier, it is important for long-term investors to separate the uncertain and often disheartening macro concerns from the constructive investment opportunities that exist or might even be a result of the policy responses to these concerns. Understanding the risks in a portfolio and capturing powerful value creating trends, while not always rewarded in the short run, should produce good long-term investment results. ■

About Gresham

Formed in 1997, Gresham Partners LLC is a nationally recognized, independent wealth management firm serving select families with investable assets of at least \$25 million. 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 nearly \$3 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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