GRESHAM

2013 Annual Outlook

Waterworld

The world is awash in a sea of liquidity, as all four major central banks of the developed world are synchronized in their aggressive implementation of easy money policies. Despite this liquidity, the global economic recovery remains the slowest on record, still hindered by the excessive leverage built-up prior to the financial crisis four years ago. While these easy money policies have produced some positive outcomes, little money is currently making its way into the real economy, but is now spilling over into capital markets, distorting prices and increasing risks to investors. While we believe many areas of the capital markets remain attractive, investors must be cautious in deploying capital to ensure that they are adequately rewarded for the risks they are taking.

Summary

2012 was a good year for investors, as most asset classes generated strong returns well in excess of inflation and long-term return expectations. World equity markets, including emerging market equities, bested U.S. markets, reversing a multi-year trend. One notable exception were high-quality fixed income markets, which through a combination of low current yields and little room for further appreciation, provided only modest returns to investors.

As we begin 2013, global economic growth remains muted, with positive news coming from the U.S. and China, while Europe has slid into a "double-dip" recession. Many of the concerning macro issues have successfully been kicked down the road once again, as unprecedented guarantees by central banks appear to have calmed capital markets.

Central banks continue the largest monetary experiment in history. All four major developed market central banks have entered into a new phase of monetary easing, which has been helpful in sustaining a modest economic recovery and avoiding a financial crisis, but is beginning to have negative consequences. While the risk of inflation appears to be increasing, we see no immediate threat of rapidly rising prices, due to slack labor markets and new sources of low-cost energy in the U.S.

Our primary concern is that much of this liquidity is not making its way into the real economy, but has begun to spill over into capital markets, distorting prices and increasing risks to investors. Zero percent interest rates have prompted investors to seek higher returning (and higher risk) assets, causing pricing to increase in a number of areas. Initially, prices increased in long-dated bonds, but investor flows are shifting into high-yield bonds and dividend paying stocks.

We still believe attractive investment opportunities exist, but we recommend actively redeploying assets away from those areas of increasing risk. So what should investors do? Several secular themes, including the rise of middle class consumers in emerging markets and a U.S. energy revolution are powerful trends that can anchor an investment portfolio. At the same time investors must recognize that their primary risk-reduction technique, diversification, is less effective in today's environment of higher correlations among asset classes more specifically, and there is no easy solution to this problem.

- Investors should continue to underweight high-quality fixed income. The current yields on bonds are quite low as is the potential for future appreciation. Additionally, risks have increased due to persistent deficits and increasing debt levels.

- Equity markets, despite good recent performance, appear to be reasonably valued and corporate earnings should continue to grow despite the low global growth environment.

- Emerging market equity valuations appear attractive relative to U.S. markets. Active management is particularly important as passive, index-based investment solutions provide investors with only limited exposure to companies that will benefit from the rapidly growing middle class and their accelerating consumption patterns.

- European equities also appear cheap. Caution is warranted, however, as many of these companies likely deserve to trade at significant discounts to their U.S. peers, due to their slower growth potential and other considerations.

- Private equity remains a key long-term driver of portfolio returns. Our commitments are rebalancing toward the U.S. from a strong emerging markets orientation, as that opportunity is now more competitive than in years past. In the U.S., we remain focused on smaller, less efficient opportunities and markets.

- The risk of inflation is increasing, but likely still off in the future. We continue to believe the opportunities in illiquid real assets that provide inflation protection are more attractive than liquid investments, as these investments are more likely to generate returns while investors wait.

2012 Capital Market Review

From an investment perspective, 2012 ranks as a good year, with most asset classes generating total returns comfortably in excess of inflation. Unlike 2011, when positive returns were difficult to find, investors experienced good returns in 2012 across a wide range of asset classes and sectors. Are investors feeling better about the risk in the world or have they simply tired of earning 0% in money market funds and are stretching to find yield and return? We believe a bit of both.

Treasury and municipal bond performance was modestly positive, returning 3% to 4%. On the other hand, riskier fixed income instruments such as high-yield bonds and emerging market debt performed well, returning between 10% and 18% respectively, as investors reaching for additional yield compressed credit spreads in all sectors of the fixed income market, as shown in Table 1.

World equity markets finished the year up over 16%, following a disappointing year in 2011 where they registered a 7% decline. U.S. equity markets increased 16%, modestly trailing the 17% return of international markets and the 18% return of emerging markets, which ended the U.S. market's nearly three-year period of outperformance. This is somewhat surprising, as many of the world's largest economic concerns were still centered outside the U.S.

The range of hedge fund returns for the year was quite wide, reinforcing the idea that hedge funds are not an asset class, but rather a wide range of strategies with unique risk profiles and return drivers. For the year, HFRI's broad hedge fund peer group rose just over 6%, which trailed equity markets by a good margin. More market sensitive strategies, such as distressed, equity hedge and event driven strategies performed well, increasing 9%-10%, as they generally capture more of equity market movements. More conservative strategies generated 3% to 4%, consistent with their more absolute return orientation. Investors who do not have access to the better performing hedge fund managers have probably been disappointed with their allocations, as the broad hedge fund peer group has annualized at a meager 0.3% over the last two years.

Commodities have disappointed investors over the last few years and 2012 was no exception, as concerns about slowing global growth dampened investor interest. Liquid commodity markets declined over 1% for the year and have declined over 7% per annum over the last two years. Gold performed

Table 1. Market Returns and Valuations

		Performance			Valuations	
			Annualized		Price/Earnings	
Market	Index	2012	3 Year	5 Year	Dec. 2012	Jan. 2012
U.S. Equity	S&P 500	16.0%	10.9%	1.7%	12.7x	11.7x
International Equity	MSCI AC World ex U.S.	16.8%	3.9%	-2.9%	14.8x	15.1x
Emerging Market Equity	MSCI Emerging Markets	18.2%	4.7%	-0.9%	10.6x	9.3x
					Spread vs. Treasuries	
U.S. High Yield Bonds	Barclays High Yield Corporate Bond	15.8%	11.9%	10.3%	549 bps	724 bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	18.5%	12.9%	10.5%	271 bps	426 bps
Municipal Bonds	Barclays Mgd Money Short/Int	3.0%	4.9%	5.4%	73 bps	94 bps
Hedge Funds	HFRI Fund Weighted	6.2%	3.5%	1.5%		
Conservative Hedge Funds	HFRI FOF Conservative	4.1%	1.8%	-1.5%		
Commodities	Dow Jones UBS Commodity	-1.1%	0.1%	-5.2%		
Gold	Spot Price of Gold	7.1%	13.5%	14.0%		

Source: Bloomberg, MSCI, JP Morgan

well for investors, as governments continued to print money and debase their own currencies, causing investors to seek hard currencies that will hold their value.

Looking forward, the positive returns we witnessed in 2012 may continue, but we are beginning to see higher prices and compressed risk premiums in some commodity sectors, which will lead to lower future returns and increasing risk for investors.

Global Economic Environment

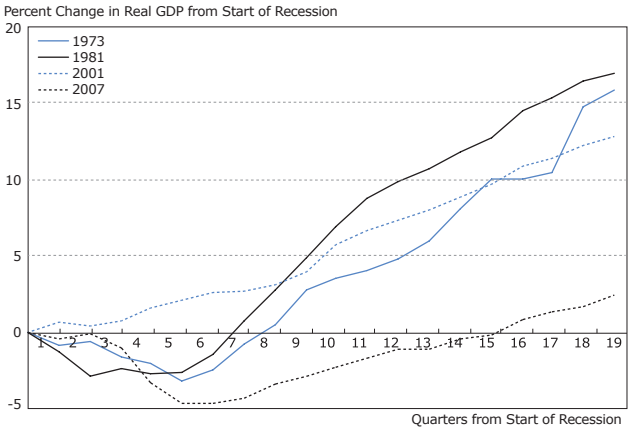
The global economy continues its slow recovery, with better news in the U.S. and China, while Europe continues to struggle. Relative to history, the current recovery remains the slowest on record as shown in Chart 2. This is to be expected coming on the heels of the biggest credit bust of all time and with the typical business cycle remedies of lower interest rates and fiscal stimulus proving to be less effective.

The U.S. appears relatively healthy when compared with Europe. Over the next few years, we expect that U.S. growth will remain subdued, as the recovery will continue to be weighed-down by the ongoing deleveraging of the U.S. consumer and some combination of higher taxes and/or reduced spending to bring our federal deficits and exploding entitlement spending under control.

However, we see positive signs that the U.S. economy is healing from the recent financial crisis. U.S. corporate profits have been the one aspect of this recovery that is well above the trend of past cycles as shown in Chart 3. Despite slower wage growth during this recovery, the U.S. household sector is in good shape compared with other developed nations. Household net worth has rebounded back near pre-crisis levels as shown in Chart 4. This is particularly important for the U.S., where the consumer accounts for more than 70% of the economy.

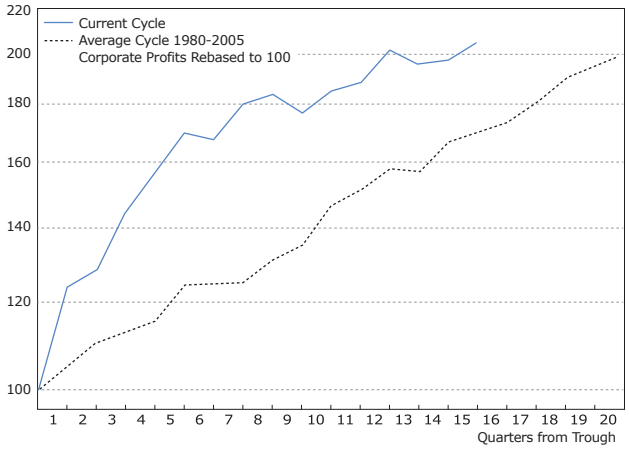
U.S. banks are also much healthier than their European peers, as efforts to recapitalize balance sheets

Chart 2. Current Recovery Slowest on Record



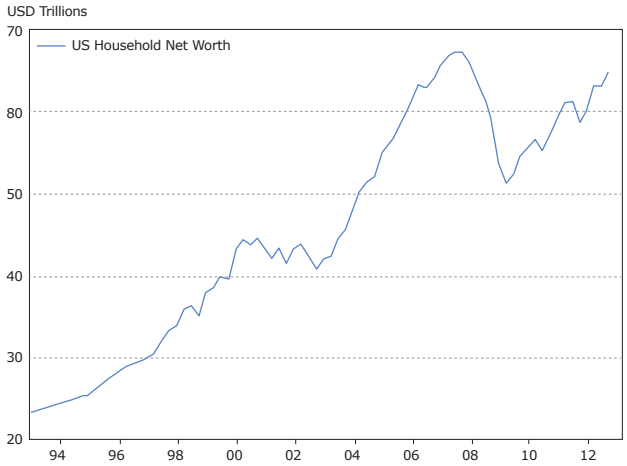
Source: Federal Reserve Bank of Minneapolis

Chart 3. US Corporate Profits have Boomed Despite Weak Economic Recovery



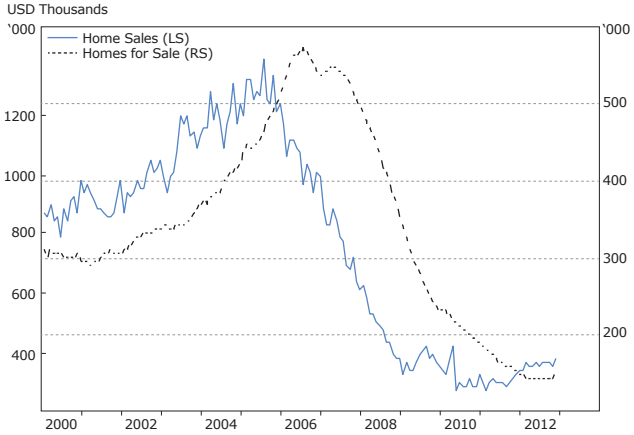
Source: Boeckh Investments Inc., Thomson Reuters Datastream

Chart 4. Household Net Worth Levels Approaching Prior Peak



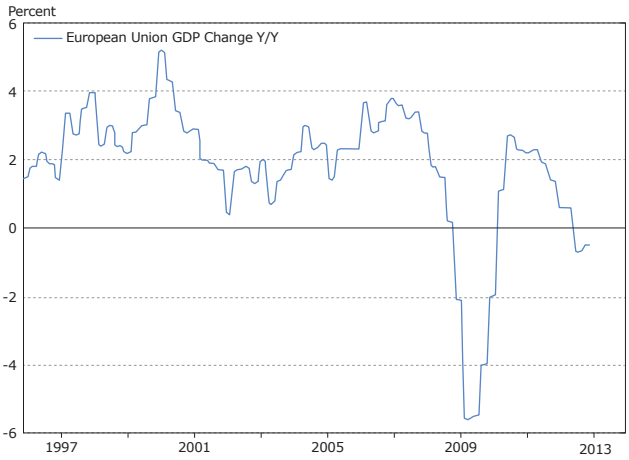
Source: Thomson Reuters Datastream

Chart 5. US Housing Market has Stabilized



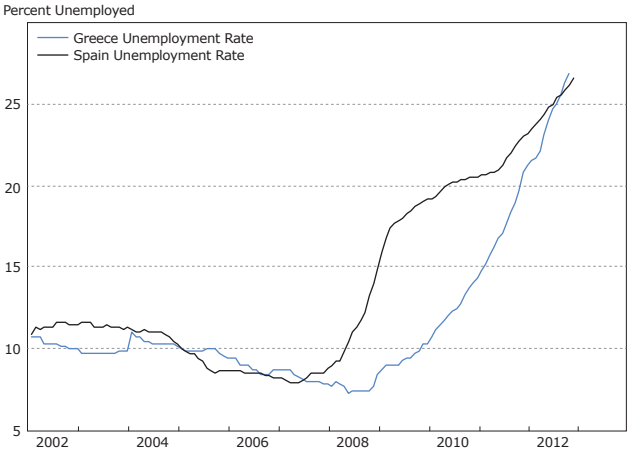
Source: © BCA Research 2013

Chart 6. Eurozone Entering Double-Dip Recession



Source: Gavekal Research 2013

Chart 7. High Unemployment in Peripheral Europe is Leading to Social Unrest



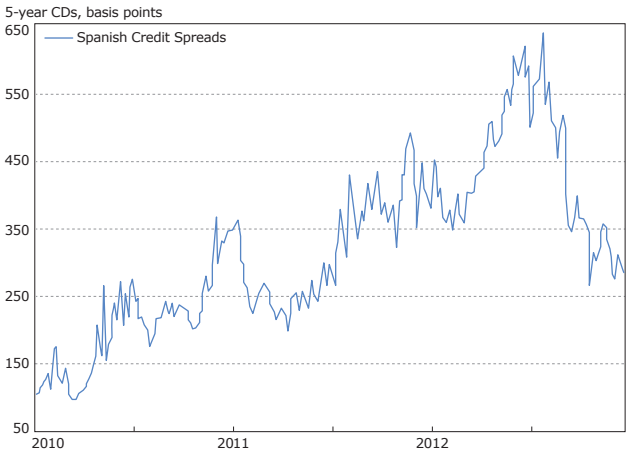
Source: © BCA Research 2013

and clean-up poor performing loans appear to be having a positive effect. Additionally, the housing sector, which has been a significant drag on the U.S. economy over the last several years, is improving as shown in Chart 5. While we don't believe that the housing sector will be a significant source of growth for the U.S. economy, the removal of a large negative is an important positive development.

On the other hand, Europe appears to have fallen back into its second recession in five years, as shown in Chart 6. The health of the European banking system remains a serious question and most European labor remains uncompetitive. Europe is suffering from a competitiveness problem that is leading to an acute shortage of economic growth, whose absence will make it difficult for politicians to find lasting solutions. Additionally, unemployment is reaching levels that are creating social unrest as shown in Chart 7.

On a positive note, the European Central Bank's ("ECB") mid-year pledge of unconditional support appears to have calmed (at least for the moment) fears of the Eurozone splintering. Additionally, the ECB's actions have pacified debt markets, as shown by the decreasing debt spreads in Chart 8. While nothing has yet been solved, the politicians were able to celebrate another successful episode of "kicking the can down the road," giving nations more time to solve their budgetary imbalances and begin

Chart 8. ECB's Bond Buying Program has Calmed Europe's Debt Market.



Source: JP Morgan

to work down some of their existing debt.

On the other side of the world, China appears to have successfully navigated a once-in-a-decade leadership transition while maintaining its economic status as the world's fastest growing large economy. Early indications from the new leadership appear positive for ongoing market reforms and the potential for further growth. GDP appears to have increased around 7% in 2012, which is down from the double digit gains of the prior decade, but enviable nevertheless. We continue to view China as the key driver of Asian growth over the coming years.

The Great Monetary Experiment Continues

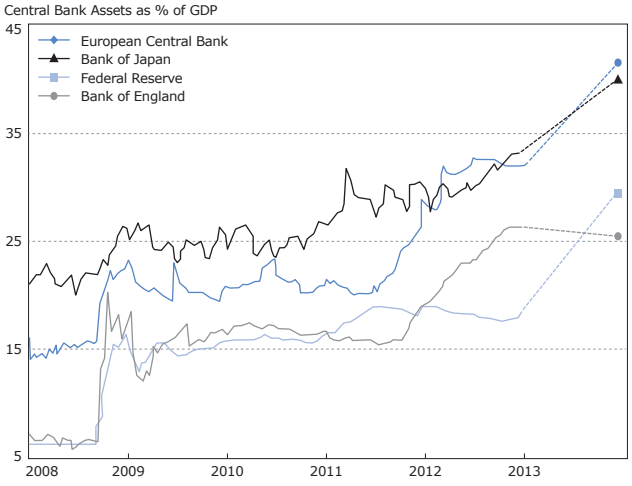
A review of today's economic environment is not complete without a discussion of central bank activity. Quantitative Easing or "QE" has unfortunately become part of our everyday vocabulary and the guiding philosophy of central banks around the world. At the end of 2012, we moved into a new phase of the largest monetary policy experiment in history, as the ECB, the Federal Reserve ("Fed") and the Bank of Japan ("BOJ") all announced new initiatives designed to inject more money into the world economy, bringing a whole new meaning to the term "synchronized swimming." Chart 9 shows the balance sheets of the four major central banks of the developed world, the historical expansion of their balance sheets and their projected path based on previously announced programs.

Of more concern is the recent trend by governments to reduce the independence of central banks and force monetary policy to recognize broader (i.e. non-monetary) goals, which increase the chance of higher inflation in the future. For investors, higher inflation essentially amounts to an annual tax on their portfolio.

Most economists acknowledge that additional QE initiatives will be ineffective in stimulating employment or economic growth, as the global economy simply can't digest all of this liquidity. So why continue? While economic growth and job creation has not occurred as many hoped, we should acknowledge several positive effects.

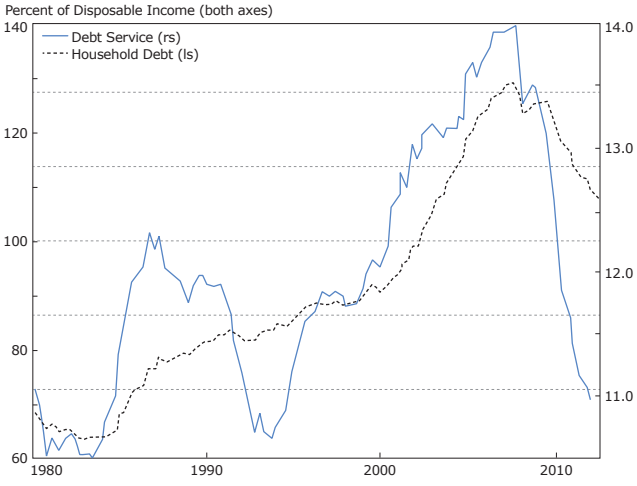
First and foremost, the actions by central bankers in the early days of the financial crisis likely averted a much more significant recession and possibly a full blown banking collapse. Several years later, it looks like these low interest rates have provided an opportunity to work through the beginning of a long deleveraging process. Chart 10 shows that household debt service has declined by nearly 25% over the last few years, which has helped U.S. households to deleverage their

Chart 9. Global Central Banks are Conducting Large Monetary Policy Experiments



Source: JP Morgan

Chart 10. Lower Interest Rates are Helping Consumers Delever



Source: JP Morgan

balance sheets, as household debt has declined from 130% of disposable income before the financial crisis to under 110%.

Is QE Increasing the Risk of Inflation?

Inflation is caused by an excess of money and credit, creating upward pressure on prices. But what constitutes "excess" is difficult to determine in today's environment. The traditional mechanisms that translate money into economic activity remain temporarily out of order. For example, in a typical environment, lower interest rates would lead to increasing demand for credit. Today, consumers are still trying to work out from under large debt loads accumulated during the last decade so that credit demand is positive, but quite weak. Similarly, lower rates typically lead to additional business investment and hiring, but corporations have been reluctant to hire, given an uncertain economic and regulatory environment. This leaves employment weak and the gap between potential GDP and current GDP quite wide, as shown in Chart 11.

Consequently, inflation remains well behaved in the 2% to 3% range in the U.S. and many other countries. As we look forward, we believe the risks of inflation are increasing, but the timing is uncertain. Investors shouldn't fear a rapid increase in general price levels, as slack in the economy and downward pressure on U.S. energy prices are likely to keep inflation under control, at least in the near-term.

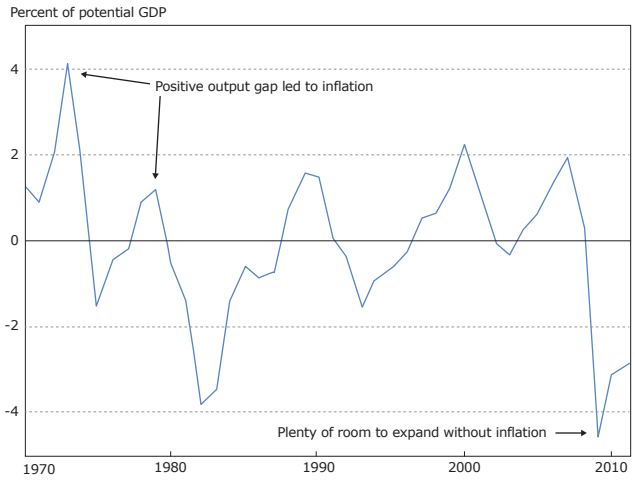
Is QE Distorting Markets?

In a word, "Yes." While excess money is not yet creating inflationary pressure in the real economy, it is making its way into the prices of assets such as bonds and real estate, creating pricing distortions in capital markets. Massive QE policies have made central banks the largest investor in bond markets and, in some cases, have entirely crowded out private investors.

Chart 12 shows that the U.S. Federal Reserve is expected to purchase an amount equivalent to nearly 100% of the entire net issuance of all bond markets in 2013. While it is difficult to say the bond market is a bubble, we can say that interest rates in these markets are artificially repressed, as the free market price setting mechanisms have been overridden. This presents additional downside risk for bond investors in these markets.

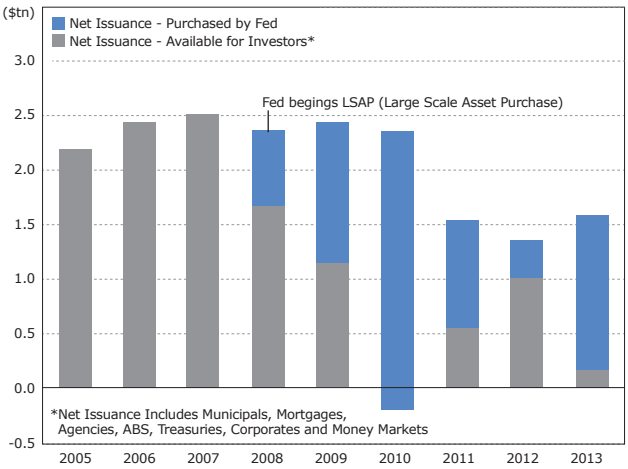
Zero interest rate policies have also been effective in driving investors from cash and money market funds into riskier assets. Initial investor asset rotation focused on higher yielding bonds, such as corporate bonds and high yield bonds, driving those prices higher. Now, investment flows are making

Chart 11. Economy Running Below Capacity Preventing Inflation



Source: JP Morgan

Chart 12. US Federal Reserve is Crowding Out Bond Investors



Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research Estimates

their way into even riskier assets, such as real estate and dividend paying stocks, as we are beginning to see asset prices increase in these areas as well. This is changing the risk profile of certain assets as we describe in more detail later.

What Should Investors Do?

Asset Allocation Considerations

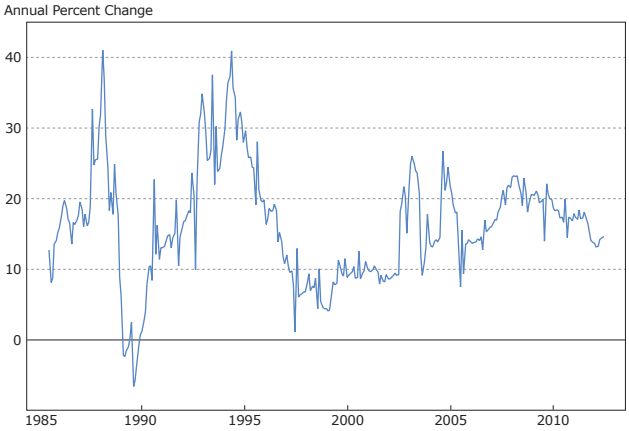
It is important to design a portfolio to capture powerful long-term trends, allowing investors to ignore the noise and distractions of short-term events. In today's environment we see two important secular trends that are worthy of consideration when building a portfolio: 1) emerging markets consumers continue to expand both in number and purchasing power and 2) the U.S. and a few other countries are in the midst of an energy revolution that will fundamentally alter the global economic landscape.

Against these considerations, investors should be mindful of two significant challenges: 1) correlations amongst assets remain high, reducing the effectiveness of diversification within a portfolio, and 2) risk premiums are becoming compressed increasing the risk of investing in certain asset classes.

Emerging Markets: The growth of emerging markets is not a new story, but it is enduring. However, the future source of growth in these economies is changing from the old manufacturing and export driven economy to one more centered on their growing middle class and rapidly expanding discretionary spending. Chart 13 shows the persistence of emerging market retail sales growth over the last few years, including the financial crisis period when most developed market consumers spending patterns declined significantly.

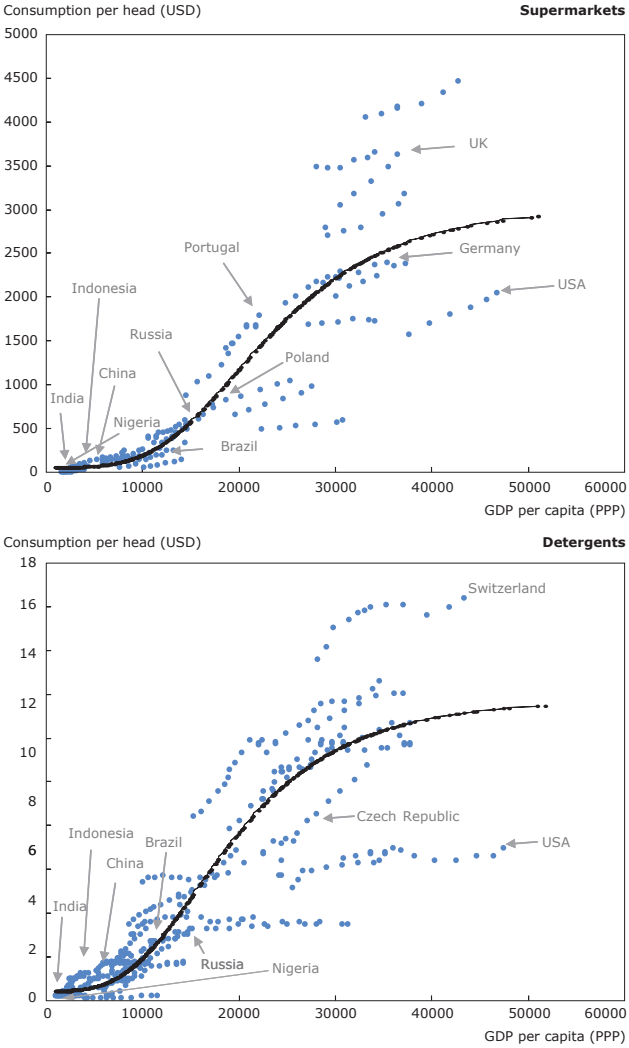
Additionally, Chart 14 shows two consumer "S-Curves" examples, in this case supermarkets and detergent, of how consumption increases at an accelerating rate as GDP per capita reaches certain milestones. You can see several of the emerging markets in the lower left corner and the likely path they will follow as these economies continue to grow. These powerful

Chart 13. China Retail Sales Growing at an Attractive Rate



Source: © BCA Research 2013

Chart 14. Emerging Market Consumption is Just Beginning a Decades Long Growth Pattern



Source: Euromonitor International, Arisaig Partners

trends across a wide range of goods and services should create decades-long investment opportunities if one can gain the appropriate access.

Energy Revolution: The U.S. is in the midst of an energy revolution. The International Energy Association recently estimated that the U.S. will overtake Saudi Arabia and Russia as the world's top oil producer by 2017, bringing the U.S. ever closer to its goal of energy independence. This rebound in production has been driven by technological improvements that are allowing for the extraction of oil and gas from tightly packed shale rock formations that are prevalent in the U.S.

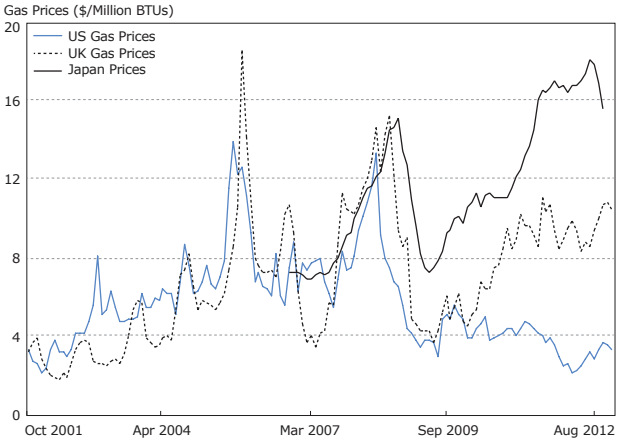
Lower energy prices provide a strong deflationary influence that will benefit U.S. consumers and create powerful incentives for businesses to locate in the U.S. and capture the competitive advantage created from lower energy prices as shown in Chart 15. In addition to attracting new businesses, the U.S. may begin to develop a significant natural gas export business, as the price differential between U.S. gas and overseas gas has become quite large.

One note of caution is warranted. While we are quite bullish on the opportunities created by these secular themes, it is important to remember that the U.S. and other developed nations remain in a period of deleveraging that will dampen global economic growth for years to come. We are already five years into this deleveraging period and have clearly felt its dampening effect on growth during the recent recovery period. Investors should likewise dampen their expectations.

Diversification is Less Effective

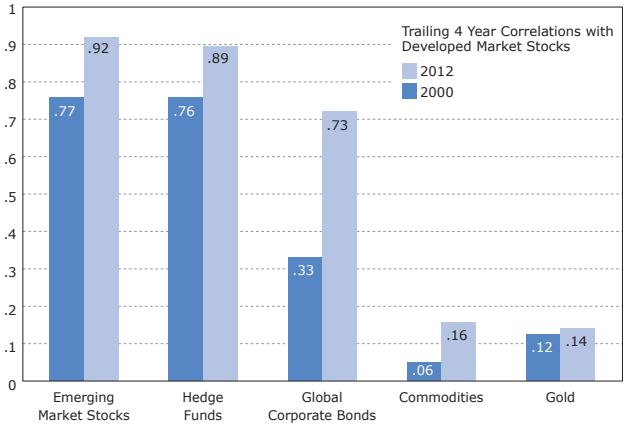
Over the last few years, increasing correlations across asset classes have reduced the effectiveness of diversification as a key risk reduction tool for a portfolio. Chart 16 demonstrates this trend. As a result, most investors' portfolio volatility is likely higher than they might expect. We believe that correlations among asset classes will remain elevated for some time, as QE policies drive investor flows into an increasing range of asset classes, making investment returns less driven by fundamentals and more reliant on liquidity and investment flows.

Chart 15. US has a Competitive Advantage in Energy



Source: Bloomberg

Chart 16. Increased Correlation Across Asset Class Reduces Effectiveness of Diversification



Source: Bloomberg

To further complicate the challenge investors face, some of the assets with the most powerful diversifying characteristics (i.e. the lowest correlations), such as high-quality fixed income, have become overvalued and increasingly risky. As investors continue to reallocate their portfolios toward higher income producing investments, such as high yield and emerging market debt, they have also increased the correlation of their investments to equities and unwittingly increased the overall risk in their portfolio. Chart 17 shows the correlation of various fixed

income investments to equity markets.

Unfortunately, there is no easy remedy to the challenge of investing in a highly correlated world. Investors may simply need to resign themselves to more volatility in their portfolio or make proactive allocation changes to lower volatility assets that will also likely result in reduced return expectations.

Prices and Risk Are Increasing… In Some Places

Clients and long-time readers will remember that we believe one of the most important drivers of investment risk is price. All things being equal, the higher the price an investor pays for an asset, the lower the probability of achieving a favorable outcome. At the moment, QE policies are creating distortions in the capital markets, including upward pressure on asset prices in many markets, thereby decreasing expected future returns for investors. One of the great truisms of Wall Street is, "Don't fight the Fed." This was originally meant as a warning to investors that when the Fed began to hike interest rates, it typically meant that bad news for stocks was soon to follow. We think the saying is equally true in reverse. If the Fed continues its zero interest rate policies, asset prices will likely continue to increase.

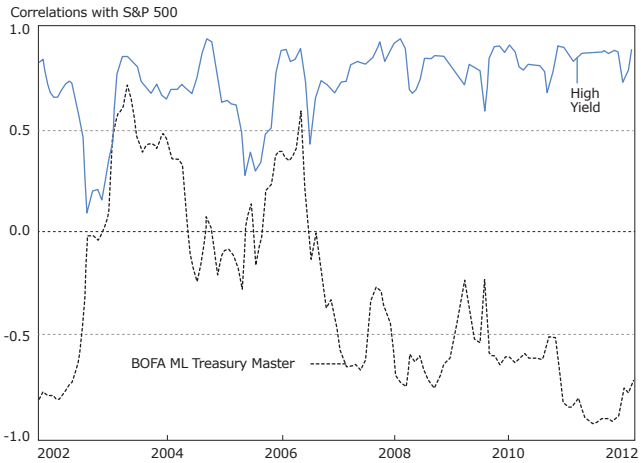
We have seen this type of risk premium compression many times before, most recently during the middle portion of the last decade. We don't believe that we are back to the peak levels of 2007-2008, so it's not time to run away, but investors should be mindful of increasing valuations and ensure they are being properly compensated for the risks they are taking in their portfolios. When markets lose their discipline, it is up to disciplined investors to reallocate their portfolios, which leads us to our investment themes.

Investment Themes

Fixed Income

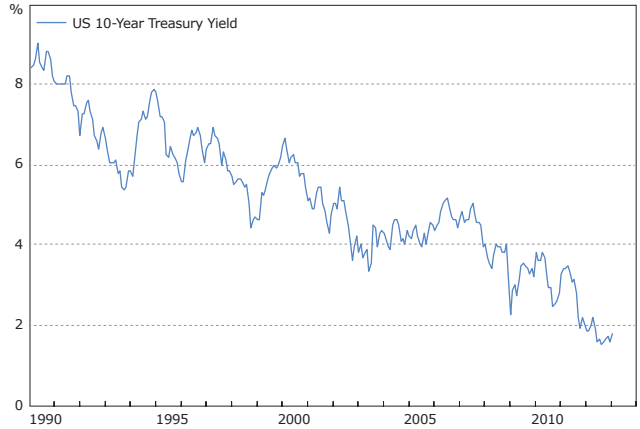
Over the last few years, we have recommended investors reduce their high-quality fixed income allocations. We believe that the reward to investors through current yields, which are near historic lows,

Chart 17. Higher Yielding Fixed Income Offers Little Diversification Benefit



Source: © BCA Research 2013

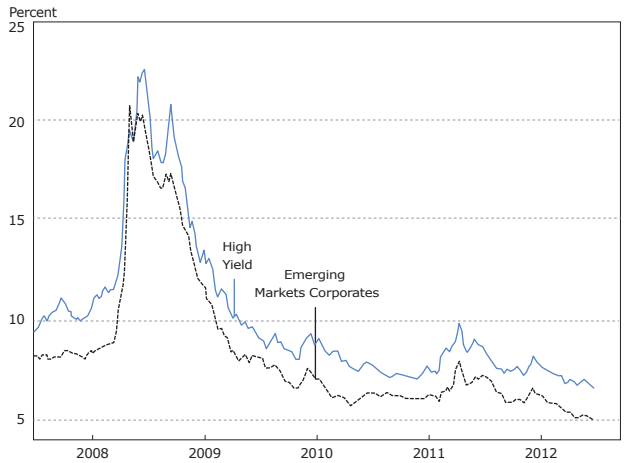
Chart 18. Low Return Expectations for Fixed Income



Source: © BCA Research 2013

and the potential for appreciation resulting from lower interest rates, has been significantly reduced. Further, the risks of these investments, due to deteriorating credit fundamentals, are increasing. Chart 18 shows the ongoing progression of Treasury rates to record low yields, highlighting the reduced return expectations for fixed income investors. While our prior recommendation in 2011 was early, this reallocation was exceptionally helpful to portfolios in 2012, as investment-grade fixed income underperformed most other areas of the capital markets. We continue to recommend reduced allocations to this area.

Chart 19. Investors have Driven Yields to Record Lows



Source: Boeckh Investments Inc., Thomson Reuters Datastream

Chart 20. US Equity Markets are Trading at Reasonable Levels

Source: © BCA Research 2013

Relatedly, we are now seeing increased valuations (and lower yields) in some riskier fixed income investments, such as high yield bonds as shown in Chart 19. While these areas have been productive investments over the last few years, they are becoming riskier due to increased valuations. Our clients currently own little of this exposure and we recommend that others consider reducing their allocation to this area.

Equity Markets

Equity markets around the globe provided investors with strong returns in 2012. Unlike the shrinking risk premiums we see in fixed income markets, equities remain reasonably valued by historical standards. Today, as shown in Chart 20, the S&P 500 trades at 13 times forward four quarter earnings, which is modestly below its long run average. Earnings growth appeared to slow in the third and fourth quarter, but analysts estimate the S&P earnings per share should increase by nearly 10% in 2013. While this is not exceptional by historical standards, it is a good result in a world where GDP growth is slow and corporate revenue growth will likely remain subdued. In a world of low GDP growth, corporations that have the ability to adapt quickly to changing markets and regulations provide investors with the potential for growth, as productivity enhancements can generate profit growth.

The growing profits and healthy balance sheets of global corporations may represent an alternative form of a "safe" investment that provides investors with the best chance of protecting and growing assets over the long-term. Traditionally safe assets are experiencing deteriorating credit worthiness, due to persistent deficits and high debt levels, and offering yields that remain near historic lows. Investors should note that equity investments are not safe in the traditional sense of providing low volatility and protecting against portfolio drawdowns. However, they may be best equipped to protect and grow capital over the long-run as long as investors can hold their positions through volatile periods.

In Europe, GDP growth is negative making the corporate challenge even greater, but many European multi-national companies focus on higher growth markets outside Europe in pursuit of revenue growth. Moreover, valuations for European stocks have become relatively inexpensive, as markets have embedded low growth expectations into stock prices. Chart 21 shows that European valuations are trading near their widest discount on record when compared with U.S. stocks. As a result, we recently increased our allocations to European equities.

A note of caution is warranted, as one European-focused manager stated that these attractive valuations are not always found in the companies that

we want to own. Accordingly, we believe disciplined active management, rather than passive equity exposure, is critical to exploit this idea.

Emerging Market Equities

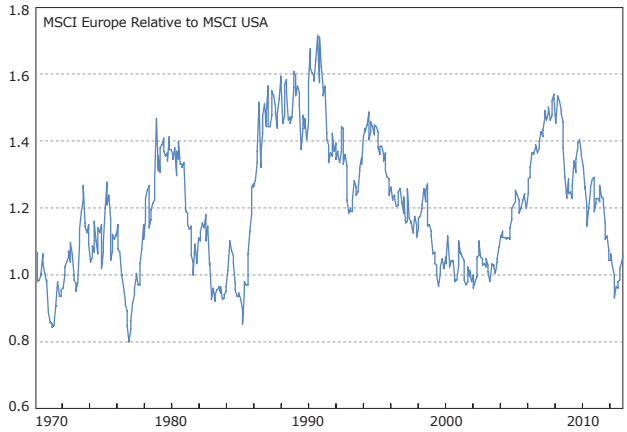
Emerging market equities finally produced good returns for investors in 2012 after several years of underperforming U.S. equity markets as shown in Chart 22. For several years, we have recommended that investors increase their exposure to emerging markets. This view was based on the strong tailwinds created by the rapidly growing middle class and their discretionary consumption described before.

Today, emerging markets continue to trade near historic lows in valuation as shown in Chart 23. We continue to believe a significant overweight is appropriate and we continue to look for opportunities to increase our exposure to the area. How we structure this exposure is even more important than the overall allocation and is changing as these markets mature.

The primary challenge we face in implementing an emerging markets investment strategy is accessing consumer oriented companies. Chart 24 shows that the sectors that comprise emerging market equity indices are heavily weighted in the industrial, utility, energy and banking sectors. These companies are often less-efficient, slower growing and state-run enterprises that will not provide the strong earnings growth and hence capital appreciation that investors seek.

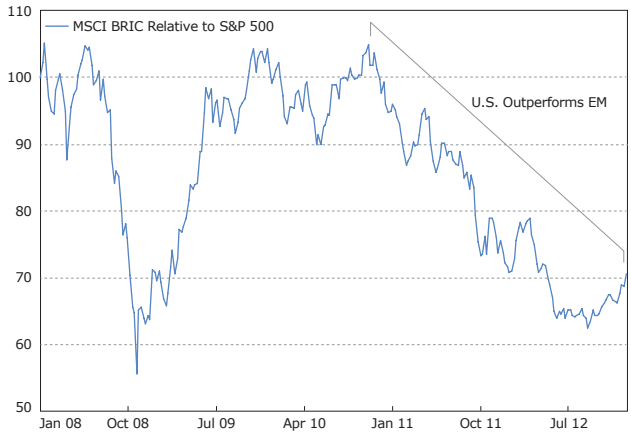
During the middle of the last decade, the companies we sought were not yet publicly traded. The solution we found was to own these companies through private equity investments with well-qualified local managers. Today, many of these companies are beginning to go public and, over the coming years, the sector weight of these indices will become more balanced. Consequently, we feel more comfortable increasing our public market exposure to emerging markets. However, passive index investments, and most active managers who use an index as a reference point for

Chart 21. European Equities Trading at Discount Relative to the U.S.



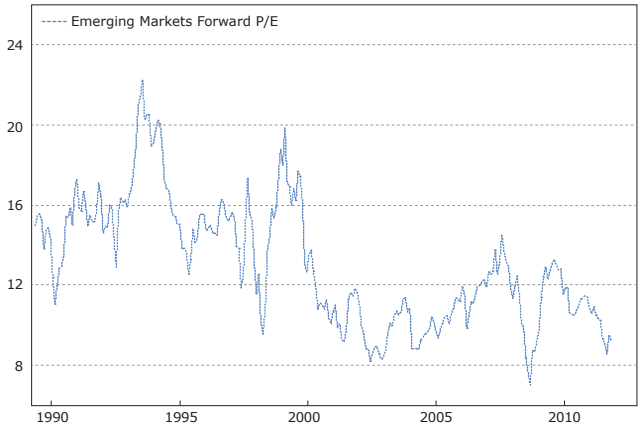
Source: Bloomberg

Chart 22. Emerging Markets have Fared Much Worse than Developed



Source: Bloomberg

Chart 23. Emerging Markets Valuations are at Relatively Low Levels



Source: © BCA Research 2013

Chart 24. EM Equity Indices Dominated by Older, Slower Growing Sectors

	U.S. (S&P 500)	Brazil (Bovespa)	China (SSE)	India (Sensex)	Russia (Micex)
Consumer Sectors					
Consumer	22%	15%	6%	9%	1%
Healthcare	12%	-	3%	3%	-
Information Technology	20%	2%	2%	18%	-
Total	**54%**	**17%**	**11%**	**30%**	**1%**
Non-Consumer Sectors					
Energy/Utilities	15%	35%	31%	31%	69%
Financial	15%	20%	39%	16%	16%
Industrials	10%	3%	12%	1%	1%
Materials	4%	21%	6%	11%	11%
Telecom	3%	4%	1%	2%	2%
Total	**47%**	**83%**	**89%**	**61%**	**99%**

Source: Capital IQ as of December 2011

their portfolio, still have high exposure to these old companies. We believe disciplined active management that is importantly not closely tied to a benchmark is the most effective manner to exploit these opportunities in the public markets.

Private Equity

Private equity remains an important driver of long-term performance for our clients. However, proper implementation of this strategy is critical to achieving investment success. During the last decade, the large buyout funds captured record fund raising dollars. These war chests created immense price competition that was further fueled by the extensive use of cheap leverage, increasing risks to investors. Our response was to deploy significant capital toward the opportunities in emerging markets and specifically China, which appears to have been a very productive decision.

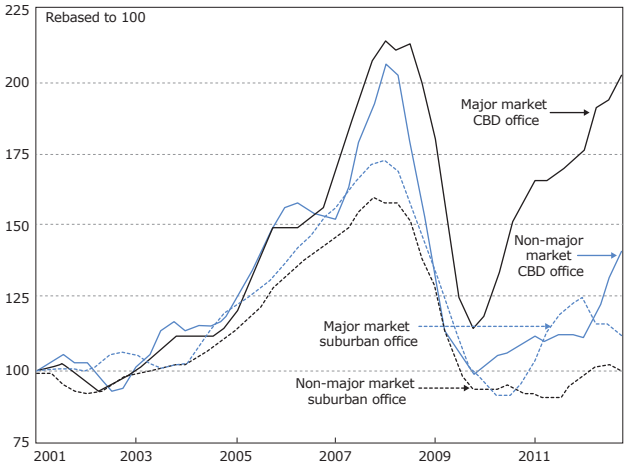
In China the opportunity is still attractive, but not nearly as much as it was several years ago. Most of the successful firms are raising larger funds, limiting their investment commitments, and the industry is becoming more competitive. As a result, while we still plan to emphasize China, we are rebalancing our portfolio investments back to the U.S. where we are focusing on smaller, less competitive buyout and venture capital investments.

Real Assets

With the risk of inflation beginning to increase, we feel that it is important that portfolios are structured with exposure to investments that will perform well in a period of high inflation, which historically has been devastating to bonds and can present difficulty for many stocks. As we discussed earlier, we don't think inflation is an immediate threat, so the challenge will be timing the creation of this exposure or building an exposure that pays an investor while waiting. We strongly prefer the latter approach, but these strategies are often only available in non-marketable investments, requiring a longer investment horizon, which can be a difficult trade-off for some.

Many investors correctly view real estate as an investment with some inflation hedging characteristics. Unfortunately, real estate is one of those areas where we see increasing valuations and risks, as investors have sought income producing alternatives. Chart 25, on the following page, shows that core assets, such as major market, prime office properties, have appreciated back near their record, pre-crisis levels.

Chart 25. Major Market Core Property Valuations Approaching Pre-Crisis Record Levels



Source: JP Morgan

Non-core properties, particularly those in lesser locations, have appreciated far less. This may present an opportunity for value-added real estate investors, who can purchase lower-priced assets and transform them into core properties, still creating decent returns for investors with the right active management.

As values in real estate appreciate, we are increasingly turning toward natural resources, where opportunities appear relatively more attractive and durable. These investments also seek to take advantage of the disruptions that are occurring in the sector, as new lower-cost supply is crowding out established, higher-cost production. Our interest continues to be more in the upstream extraction opportunities rather than the mid-stream infrastructure investments, which appear to be reaching high prices given their more consistent income characteristics that are attractive to today's yield hungry investors.

Liquid investment in commodities can offer investors similar inflation protection. Unfortunately, the performance of liquid commodities has only been positive during limited windows over time. Technological innovation has been the primary reason we have seen structural price declines in broad commodity prices. We are witnessing this first-hand in the natural gas industry today. Investors should understand that expected returns in these investments will be significantly lower than long-term equity investments unless we move into an inflationary environment. However, allocations to this area are still appropriate for investors who correctly view this as a form of portfolio insurance.

As with other areas of the capital markets, how an investor accesses natural resources strategies is critical, as the common indices are flawed and many passive investments have significant structural deficiencies that can make these investments perform quite poorly.

Currency Debasement

Gold has generally been a productive investment for portfolios over the last few years as the price has risen significantly. Contrary to popular belief, gold is not an inflation hedge, but rather an alternative currency that protects against the debasement of paper currencies. Over the last decade and particularly the last few years, we have lived in a world of negative real interest rates and aggressive money printing, leading to increased interest in gold.

As we discussed earlier, we expect that QE programs will continue for the foreseeable future, which will likely sustain investor interest in gold. We recognize that gold is difficult to value and its price movements are often unpredictable and psychologically based, but we continue to recommend that investors maintain a modest exposure to protect against financial uncertainty and the ongoing debasement of the major currencies in the world.

On the other hand, equities of companies in the precious metals business have been a poor investment over the last two years. The prices of these companies have not increased with the price of gold and now trade near their cheapest level in decades based on price-to-earnings or price-to-NAV measures.

Tax Efficiency

For taxable investors, the integration of taxes into investment decisions has become more important given recent tax increases. Many believe we are only in the first stage of tax increases from the

relatively low rates of recent years. Investments that generate ordinary income or short-term gains as their primary form of return have become marginally less attractive to investors. While there are no generic rules that can provide investors with guidance on this subject, the impact of taxes should not be ignored.

Concluding Thoughts

As the world becomes more complex, often the simplest ideas can be the most powerful. None of the secular themes we identified as the foundation of a portfolio are unique to Gresham. What is unique is our emphasis on risk and effective implementation of the investment ideas. Our experience has shown that simple ideas can often go astray as investors seek to implement them in a portfolio, giving little credence to market composition, manager selection and the choice of when to seek active investment solutions rather than passive approaches. In other words, while asset allocation is important, we strongly believe that portfolio implementation and particularly manager selection, as described in our investment themes, is a critical aspect of successful investing that is given far too little credence by today's conventional investment wisdom.

About Gresham

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

Gresham Partners, LLC | 333 W. Wacker Dr., Suite 700 | Chicago, IL 60606
312.327.5020 | info@greshampartners.com