

Summary

Investor Education (Page 3)

- We will highlight examples of key cultural differences and similarities between conducting business in China, Hong Kong, South Korea, and Japan to highlight how misdirected a statement like “Asia looks attractive” could be when there are substantial differences amongst nations in the region.

World Economic Review and Outlook

US Economy (Page 5)

- The US economy continues down the recovery path for the year despite additional headwinds faced in the first quarter, including social unrest in the Middle East/North Africa and the subsequent rally in energy prices, European sovereign debt and financial sector challenges, and the devastating impact of a 9.0 magnitude earthquake off the coast of Japan.

Foreign Developed Economies (Page 6)

- Before we begin our discussion on Foreign Developed Economies, we want to extend our deepest condolences to everyone who has lost a loved one due to the recent earthquake and resulting tsunami in Japan.
- With Japan, we believe that the negative impact on the economy is likely to last only a few quarters, with a very noticeable recovery in the tail-end of this year.
- Europe continues to face difficulties. As we have previously discussed, we believe that the Eurozone needs to restructure certain obligations in a realistic manner so that the entire region can build a healthier future. Reflecting these views, S&P further downgraded Greek, Portuguese, and Irish debt over the past few months.

Emerging Economies (Page 7)

- Over the past few months, social unrest spread to Jordan, Egypt, Yemen, Libya, Morocco, and Djibouti. The events in most of these countries were largely ignored by the media, but hopefully they have opened the eyes of many lethargic policymakers who have been slow to address the long-term implications of inaction.
- Another powerful development was China’s National People’s Congress approving its 12th Five-Year Plan in March. Generally speaking, the plan calls for a systematic approach to increasing domestic consumer activity.

World Equity Market Review and Outlook

US Equities (page 9)

- We continue to favor US large cap equities, which have continued to outperform foreign developed and emerging market equities, but we believe in a more balanced approach now.

Foreign Developed Equities (page 9)

- Equities within the EAFE index currently have much more attractive valuations than US or emerging market equities. Their attractiveness has increased substantially over the past year, particularly since many global investors are underweight Europe and Japan. We recommend finding strong managers and returning to long-term asset allocation weights.

Emerging Market Equities (page 10)

- As expected, emerging market equities underperformed US equities on an absolute and risk-adjusted basis. However, the speed of the underperformance was unexpected. The divergence in valuations has shrunk relative to historic standards. Over the next few months, we may see EM equities perform more in line or even begin to outperform US equities.

World Fixed Income Review and Outlook

US Fixed Income (page 12)

- As we have discussed over the past few quarters, we believe that Treasury yields are just way too low and are unlikely to decline much further than these levels due to the relative attractiveness of long-term real returns. In addition, higher yields are warranted as the economy recovers, the risks of another downturn subside, and the demand for financing increases.

Foreign Developed Fixed Income (page 12)

- While we believe that many issues warrant a higher premium for fixed income within Europe, we believe there may be potential for European credits to begin outperforming US credits should rhetoric over restructuring certain sovereign obligations intensify.¹⁷

Emerging Market Fixed Income (page 13)

- Emerging market bonds have exhibited a remarkable resilience despite political instability, inflation concerns, the impact from Japan's natural disasters, and European sovereign stress. This has been on the back of strong fundamentals relative to high-deficit developed world counterparts. Despite sharp fund flows into this asset class, we may explore increased exposure as geopolitical risks ease and inflationary pressures fade, both of which should reduce the discount rate used in valuations.

Commodities Review and Outlook (page 14)

- While we remain constructive on Energy prices long-term, we believe that oil prices are overextended on a near-term basis.
- As we stated in July, we clearly see the benefits of having some exposure to gold given long-term inflationary pressures, increased risk in the global economy, and mounting pressures on the US Dollar. However, signs of rampant inflation are still not visible in the developed world. The US Dollar has come under pressure, but downside risks to the global economy are easing. Over the past nine months, gold has continued to rise and is trading near all-time highs as of the time of this writing.

Currencies Review and Outlook (page 15)

- While we continue to believe in the long-term devaluation of the US Dollar versus a basket of emerging market currencies, we believe that developed world currencies are trading close to the upper range of their near-term bands.
- The rhythm of US Dollar depreciation may become more volatile should the Fed become more hawkish and the US government's deficit reduction strategy becomes more credible over the next few quarters.

Investor Education

We believe that too many investors, including portfolio managers, ignore the differences and intricacies of business activities between one country and another. Instead, they focus on generalized macroeconomic variables such as GDP and CPI and apply nearly identical business valuation metrics to identify intrinsic price targets without paying sufficient attention to cultural dynamics that heavily influence future returns. We will highlight examples of key cultural differences and similarities between conducting business in China, Hong Kong, South Korea, and Japan to highlight how misdirected a statement like “Asia looks attractive” could be when there are substantial differences amongst nations in the region.

The keyword in China is Guanxi. Guanxi is a relationship-focused way of conducting business: in layman’s terms it is essentially a network based on the exchange of favors. These favors can be exercised to overcome or bypass legal obstacles, eliminate or reduce barriers to entry, and ensure business activity despite uncompetitive pricing. There is a strong sense of insiders versus outsiders with insiders sharing in the benefits and with little or no protection offered to outsiders. For example, the first McDonald’s in China had a 20-year lease on a property two blocks away from Tiananmen Square. Two years into that lease, sales were surpassing all expectations. However, McDonald’s was forced to vacate the property 18 years early to make room for someone who had more Guanxi. McDonald’s tried to seek legal recourse, but failed, which further reduced the company’s Guanxi. Partnering with individuals with sufficient Guanxi is essential for success in China. We have yet to see a business valuation model that incorporates Guanxi, yet we see billions of dollars being allocated into China.

The way business in Hong Kong is conducted is vastly different from the way it is conducted in mainland China, a development entirely due to the United Kingdom’s occupancy of the region. The UK brought the concept of free markets to Hong Kong, developing its markets, economy, infrastructure, and education. When the UK turned over control of Hong Kong to China, they did so with the agreement that Hong Kong would remain relatively independent for a number of years as a Special Administrative Region. China and Hong Kong have two different economic systems with two different governments and languages. They have different constitutions, currencies, economic markets for goods and services, labor and capital markets, systems of law, and cultural backgrounds. Yet investors with limited direct access to China, invest in Hong Kong thinking that they are getting the exact exposure to mainland China’s growth that they are seeking. Continuing with our example, McDonald’s would have had greater legal protection in Hong Kong than in mainland China.

Two vital words in Korea are Chaebol and Inhwa. Chaebol describes a system where blood related families own different companies to create a larger holding company. The primary goal of each business is to serve the family, who take active management in each company. This means that if one company in a Chaebol is performing poorly, stronger companies within the same Chaebol may take on losses to help strengthen the family. For multinational firms, this means that they are competing against the strength of conglomerates in Korea, rather than against individual companies in the same market segment. In addition, there is a very strong sense of loyalty to employees, who typically serve the family for their entire lifetime. This differs from Hong Kong and requires serious consideration in valuation analysis. Notable Chaebols include Samsung, LG, and Hyundai. Furthermore, Inhwa refers to the conduct of business with an extremely high respect for hierarchical relationships. An individual who is lower in rank and/or social status must be loyal to those with higher rank/social standing. In addition, there is a notion of equality through age and/or prestige when a foreign firm has employees visiting local firms. For example, a senior ranked individual would only want to deal with another senior ranked individual and not a junior analyst covering the company straight out of graduate school. Moreover, firms are much more likely to conduct business with established relationships, even at higher costs.

In Japan, the keywords are Keiretsu and Wa. In a Keiretsu, large banks are the majority stakeholders in companies. There is a substantial amount of cross-ownership and interlocking business relationships. Firms are much more willing to take losses for market share and are not as motivated to take risks since there are limited rewards to the upside. Similar to Korea, there is a very high respect for the hierarchal system and employees typically have lifetime employment. Unlike Korea however, a Keiretsu can be run by adopted family members and groups of professional managers, has less centralized ownership, utilizes external contractors to a higher degree, and has much deeper banking relationships. The deeper banking relationships increase the likelihood that one company would be willing to take impairments in order to help another company recover. Thus, when a company is performing poorly, a portfolio manager needs to take a look at the strength of the group, rather than just the individual company. Additionally, if a company is doing well, the investor needs to account for potential weaknesses in the Keiretsu. Notable Keiretsus include Mitsubishi, Mitsui, and Sumitomo. Wa refers to loyalty and social cohesion to the group in a society. For instance, an employee would not introduce themselves and their occupation by their title, but rather focus attention to the company, i.e. “I belong to XYZ company” versus “I am an analyst.” The group system requires members to trust each other, and as a result business transactions do take quite a bit of time, similar to those in Korea. This sense of loyalty encourages self-sacrifice for the benefit of the group, which explains the frequency of suicides when shame is brought to a company by an executive, albeit to a far less degree than in the past. As in China, strong networks and proper introductions may reduce the time it takes to build trust.

These similarities and differences have very important implications for foreign investors. If top-down analysis shows that real economic growth is nearly identical in each country and bottom-up analysis shows that all the securities

trade around the same valuation metrics, how does an investor determine if returns for Company A in Japan are going to be higher than returns for Company B in Korea? If Company C trades cheaper than Company D, both in China, based on financial statements and Porter's Five Forces, excluding Guanxi, which company is better to invest in? Unfortunately, most global managers do not consider key cultural differences that would justify higher or lower premiums between countries.

Here at GFG, as part of our multi-manager investment approach, we spend an extra amount of energy evaluating the cultural awareness of bottom-up international fund managers. There have even been times when we have shied away from a mutual fund because they did not pass this screening, despite a strong process, pedigree, and performance.

World Economic Review and Outlook

World Real GDP	Actual							Forecast	
	2004	2005	2006	2007	2008	2009	2010	2011	2012
US	3.60	3.10	2.70	1.90	0.00	-2.60	2.90	2.90	3.10
Canada	3.12	3.02	2.83	2.20	0.53	-2.46	2.90	3.00	2.75
UK	2.80	2.10	2.80	3.00	0.70	-5.00	1.55	1.55	2.10
France	2.50	1.90	2.20	2.40	0.20	-2.60	1.50	1.70	1.80
Germany	1.20	0.80	3.40	2.70	1.00	-4.70	3.60	2.70	2.00
Switzerland	2.53	2.65	3.63	3.65	1.88	-1.90	2.65	1.95	2.25
Australia	3.78	3.13	2.60	4.58	2.58	1.33	3.40	2.60	3.95
Japan	2.78	1.93	2.03	2.35	-1.15	-6.28	4.30	1.40	1.95
Brazil	5.70	3.18	3.97	6.08	5.20	-0.63	7.50	4.05	4.50
Russia	7.20	6.40	8.20	8.50	5.20	-7.80	4.00	4.50	4.40
India	7.25	9.23	9.83	9.50	7.48	7.00	N/A	N/A	N/A
China	10.10	11.30	12.70	14.20	9.60	9.20	9.70	9.50	N/A
South Korea	4.60	4.00	5.20	5.10	2.30	0.30	6.10	4.30	4.80
Mexico	4.10	3.20	5.20	3.30	1.50	-6.10	5.15	4.00	3.80

Current as of 4/21/11

Red = downward revision

Green = upward revision

Source: Bloomberg / Contributor Composite

US Economy

The US economy continues down the recovery path for the year despite additional headwinds faced in the first quarter, including social unrest in the Middle East/North Africa and the subsequent rally in energy prices, European sovereign debt and financial sector challenges, and the devastating impact of a 9.0 magnitude earthquake off the coast of Japan. As previously discussed, economic activity has been supported by a number of very powerful factors, including additional monetary easing, fiscal stimulus, and consumer and corporate strength. As the months go by, it appears as though the economy will have to become more reliant on the private sector as monetary easing and fiscal stimulus are sharply reduced.

In November, the Federal Reserve announced a second round of quantitative easing, or QE2. Since the announcement of this Treasury-repurchase program, the Federal Open Market Committee has increased the size of the Fed's balance sheet by over \$300 billion and is on pace to increase this amount by roughly \$80 billion a month through June 2011. The Fed's rhetoric suggests that committee members are unlikely to further expand the size of its monetary easing programs. Members generally claim that the economy is recovering at a moderate pace with gradual improvements in the labor market. Supporting evidence includes an improvement in recent nonfarm payroll figures, a declining trend in initial unemployment claims, and an increase in consumer spending. In addition, real business investments continue to recover on the back of healthy credit conditions for many firms. The FOMC acknowledges that total industrial production and manufacturing output growth remain muted, while consumer sentiment and the housing market remain depressed.¹

After QE2 ends in June, we believe that the Fed is likely to maintain the size of its balance sheet until there is sufficient evidence of above-trend domestic inflation. This will entail the reinvestment by the Fed of proceeds from QE1 and QE2 into Treasuries. We believe that the end of steadily increasing monetary easing will in effect lead to monetary tightening without the need to raise benchmark interest rates. Additionally, we believe that reinvesting proceeds will have a limited positive effect on the market. Assuming minimal prepayments and amortizations, fewer than 10% of securities held outright mature within 1 year and less than 40% mature within 5 years as shown in the table to the right. Reducing the size of the Fed's inflated balance sheet by selling assets or not reinvesting proceeds

Securities Held Outright		
Federal Agency Debt, Mortgage-Backed Securities, and Treasuries		
Figures in Millions	2011-04-13	%
Maturing within 15 days	21,503	1%
Maturing in 16 days to 90 days	34,903	1%
Maturing in 91 days to 1 year	86,964	4%
Maturing in over 1 year to 5 years	652,724	27%
Maturing in over 5 years to 10 years	523,925	21%
Maturing in over 10 years	1,122,719	46%
Total:	2,442,738	100%

Source: Board of Governors of the Federal Reserve System

would be further monetary tightening. This concept has largely been ignored and may have serious implications for global markets over the next year.

Fiscal stimulus is also in the process of being reduced as Congress discusses ways to reduce the US deficit. Due to the opaqueness of the fiscal budget, we are not able to accurately criticize Federal spending. That said, there are unquestionably substantial opportunities to save trillions of dollars without risking the safety and prosperity of Americans. The truth is that those with enough transparency and political power lack the chutzpah, and at this stage it looks like the brains, to increase the efficiency of the US government in a meaningful way. We reiterate that we do not have access to sufficiently detailed expense reports to make precise recommendations, but we can point out some anomalies that do warrant extra attention:

- Atomic energy defense activities are up 49% from 2001 to 2010 at the same time that we are preaching nuclear disarmament.
- The military personnel category is up 110% from 2001 to 2010 when family housing is actually down -10% over the same period.
- International security assistance is up 82% from just 2009 to 2010, conduct of foreign affairs is up 31% from 2008 to 2010, and foreign information and exchange activities are up 12% from 2009 to 2010 at the same time as we are calling for a global coordination in peace.
- Legislative functions are up 77% from 2001 to 2010.
- Meanwhile, emergency energy preparedness is down -74% from 2009 to 2010, higher education is down -15% from 2008 to 2010, and community development is down -3% from 2008 to 2010.²

Although the global economy needs continued US fiscal stimulus, US government debt is close to hitting the legally allowed debt ceiling. As a result, the criticism on Europeans for promoting fiscal austerity at the risk of negatively affecting economic growth has largely been forgotten. While we believe that the debt ceiling exists for a reason, cutting back on functions that promote long-term economic growth and prosperity, while inefficiently boosting expenditures that do not have sufficient multiplier effects hurts everyone. If research, development, and training in segments of the economy with powerful externalities that last for decades cannot be funded by the government, further public-private partnership structures need to be created and made easier to access. This does not mean wastefully tearing up perfectly fine roads and rebuilding them at an excruciatingly slow pace, but rather co-investing with the private sector to develop meaningful infrastructure, institutions, human capital, and technology. This relationship would help create jobs and lower the barriers to entry to scale brilliant ideas.³ As an example, the US Energy Department recently provided a \$1.6 billion loan guarantee to BrightSource Energy for the construction of the world's largest solar-thermal energy plant. This effectively helped reduce the financing costs typically associated with such a project, while minimizing outlays by the government. The project has also received financing from private sector firms such as Google, Chevron, and Morgan Stanley.⁴ This project creates jobs, helps reduce the dependence on foreign energy supplies, and supports a greener environment. Notably, G.E. also recently announced plans to build the country's largest photovoltaic panel factory in the US, and will explore the use of state and federal manufacturing tax credits.⁵

In summary, it appears as though monetary and fiscal stimulus may no longer be as supportive to the global economy as they have been over the past two years. As a result, we continue to look towards corporations to step up and play a larger role in the recovery. Although firms have been hiring and making private investments, the pace of business activity needs to accelerate over the next year to fill the gap left by public spending. Consumers will continue to be the wild card in the equation, as they continue to spend even as they need to deleverage.

Foreign Developed Economies

Before we begin our discussion on Foreign Developed Economies, we want to extend our deepest condolences to everyone who has lost a loved one due to the recent earthquake and resulting tsunami in Japan.

In March, a 9.0-magnitude earthquake off the coast of Japan resulted in a major tsunami. The combination of the earthquake and tsunami led to the deaths of over 10,000 individuals and countless others missing as well as massive damage to infrastructure, including homes, nuclear plants, ports, and dams.

We believe that the negative impact on the economy is likely to last only a few quarters, with a very noticeable recovery in the tail-end of this year. Over the next few months, the infrastructure damage and losses in power supply are likely to slow economic activity. However, rebuilding efforts, monetary easing, and fiscal stimulus could reinvigorate and normalize activity subsequently.⁶ The Bank of Japan has already aggressively expanded its quantitative easing program to purchase risky assets such as corporate bonds and commercial paper.⁷ The damage to inventories and production processes is likely to limit Japanese exports, which in turn has implications for supply chains around the world. However, the availability of substitute goods outside of Japan may limit the disruption to the global economy.⁸ Over the long-run,

this disaster may have implications on the progress towards nuclear energy. Many previously supportive policies may become excessively stringent, thus increasing the cost of safety measures for nuclear power plants around the world.

Europe continues to face difficulties. As we have previously discussed, we believe that the Eurozone needs to restructure certain obligations in a realistic manner so that the entire region can build a healthier future. Reflecting these views, S&P further downgraded Greek, Portuguese, and Irish debt over the past few months. At the current pace, it seems almost inevitable for a painful and subdued economic growth environment to last far longer in Europe than in the US. More recently, we are hearing increasing oratory about restructuring Greek debt with the support of Germany, which would be a powerful step in the right direction.

Last quarter we mentioned that with Greece and Ireland already in the headlines, we expect the next country to receive bailout attention to be Portugal. And indeed, the latest round of headlines included Portugal's troubles. For months, Portugal has denied the need for financial support from the international community. However, Prime Minister Jose Socrates tendered his resignation in March, agreeing to stay on as a caretaker leader until a special June election, after opposition parties refused to accept additional austerity measures aimed to fend off the need for international assistance. Recently, in response to higher financing costs and limited austerity measures, Jose Socrates went on national television articulating the need for Portugal to accept a coordinated bailout.⁹ As we alluded to in our Q2.2010 commentary, fundamentals can only be ignored for so long.

Speaking of denial, European finance ministers recently expanded the capacity of the region's backstop funding facility. The new bailout fund is set to lend €500 billion to member nations in need of cheaper financing, as it allows for the purchase of intermediate-term sovereign bonds in the primary market. The program will require contributions from all members and will replace the current program in 2013.¹⁰ We believe this is analogous to putting a larger band-aid on an infected wound. However, the markets appear to favor this new facility, particularly since it gives countries like Greece more time to do something right. The next country to come into focus could be Spain. As previously stated, we believe that Spain is very likely to dodge extreme funding pressures given its size and systemic importance coupled with the readiness of central banks around the world to assume credit risk, which in effect would help central bankers weaken their nations' currencies and increase their countries' political influence.

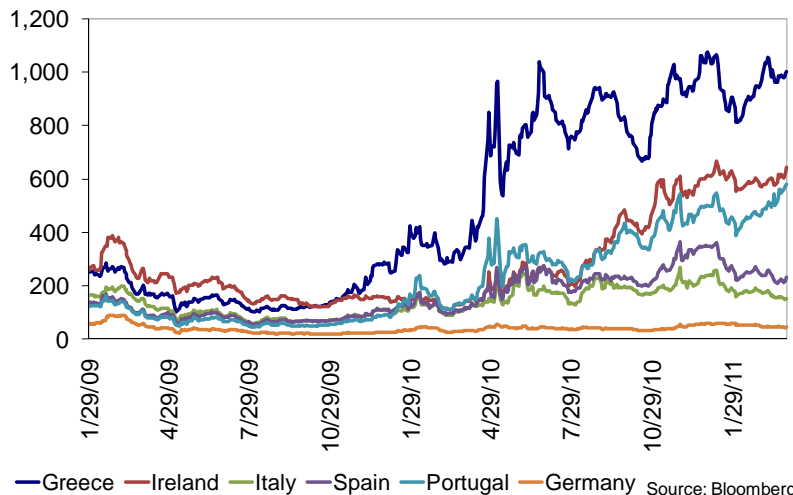
At the very time that officials are trying to lower borrowing costs for troubled nations, ECB President Jean-Claude Trichet signaled that he intends to raise interest rates to combat inflation. The market believes that the central bank is set to raise rates from 1.00% to 1.75% by year end. We believe that this is a major policy mistake and is very shortsighted, especially since we believe inflationary pressures may ease over the coming months and that the Euro has already risen considerably. Trichet is playing the same game that he played before the crisis, and we all witnessed how that game did not end well.

Emerging Economies

In our Q3.2010 commentary, we highlighted that the heart of EM inflation is food prices, which account for roughly 25% of consumer prices. In our Q4.2010 commentary, we reiterated that the largest threat to emerging market economies remains inflation. At the time of writing, the dangers of uncontrolled food inflation in emerging market nations were witnessed in Tunisia and Algeria. Over the past few months, social unrest spread from those two countries to Jordan, Egypt, Yemen, Libya, Morocco, and Djibouti. The events in most of these countries were largely ignored by the media, but hopefully they have opened the eyes of many lethargic policymakers who have been slow to address the long-term implications of inaction. We reiterate the word hope, as we suspect many have not. Additionally, and regrettably, even with political turnover, we believe it remains highly unlikely that any meaningful domestic and foreign policy changes will happen anytime soon. We suspect that new leaders will simply strengthen their political position by taking credit for improvements in the global macroeconomic environment.

Libya had and continues to receive the most attention. This is largely due to the size of the country's oil production and Muammar Gaddafi's military support, which set the stage for substantially more bloodshed than in countries such as Egypt. However, even if Libya halted oil production, it should not result in oil prices rising as fast as they have simply based on supply and demand factors. Instead, oil prices appreciated considerably more out of

5YR Credit Default Swaps
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contagion fears, in particular the fear of social unrest spreading to Bahrain, Saudi Arabia, and Iran. We believe that these fears are largely unfounded given the tight grip these countries have over protest activity and international alliances, both of which are evidenced by the historical clash between Sunni and Shiite factions. Returning our conversation to Libya, the international community and in particular the United Nations, has never responded as swiftly as it did against Gaddafi. We suspect that built up frustrations over Gaddafi's historical blunders, including his 90-minute rambling speech at the UN in 2009, encouraged countries around the world to quickly freeze assets and support an anti-aircraft program. We do not know how the situation in Libya will play out, but we hope for a resolution with minimal bloodshed.

Another powerful development was China's National People's Congress approving its 12th Five-Year Plan in March. Generally speaking, the plan calls for a systematic approach to increasing domestic consumer activity. Highlights include raising the relative growth rate of real wages, expanding service industries, and encouraging State-Owned Enterprises to distribute more of their profits.¹¹ The emphasis on domestic activity and services as opposed to exports and manufacturing may have some interesting implications for the years ahead. If consumption increases dramatically from current levels, it may divert manufactured goods away from exports and perhaps increase demand for imports. This could help developed economies, including US, Europe, and Japan, recover at a faster pace. However, it may also reduce China's current account surplus, which would limit the country's demand for US Treasuries.

World Equity Market Review and Outlook

Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P 500	5.9%	5.9%	15.6%	7.2%	13.8%
MSCI EAFE	3.5%	3.5%	11.1%	-7.2%	9.8%
MSCI EM	1.9%	1.9%	18.6%	14.0%	67.1%

USD Total Return

Source: Bloomberg

US Equities

Despite serious fundamental shocks, including the social unrest in the Middle East/North Africa and the Japanese natural disaster, the S&P 500 TR gained 5.9%. Generally speaking, small cap stocks outperformed large caps stocks. As was the case globally, the quarter's best sector was Energy, which benefited from an unexpected rally in commodity prices. Notably, all S&P 500 sectors generated a positive return.

We have been very optimistic towards US equities since we launched these quarterly commentaries. However, with the recent rally, higher commodity prices, and expected monetary and fiscal headwinds, we are diverting to a more cautiously optimistic stance. We expect additional volatility over the next few months as market participants digest these fundamental challenges. However, earnings continue to look attractive, which should continue to support performance over the next year as well as increased fund flows into equities. As we have previously discussed, most portfolios are underweight equities despite the necessary return requirements for individuals, underfunded pensions, and endowments. The fund flows that would come from rebalancing to necessary targets are likely to provide a healthy tailwind for valuations.

We continue to favor US large cap equities, which have continued to outperform foreign developed and emerging market equities, but we believe in a more balanced approach now. As Steven Romick puts it, "Generalizing (with a capital 'G'), we believe that small cap stocks are less efficiently priced, easier to understand, and more likely to be acquired, but they are less liquid, not cheaper, don't necessarily grow faster, and have less product diversification, less market dominance, and less of an international presence."¹² We have and Generally (with a capital 'G') continue to agree.

Correlations have been breaking down quite a bit over the past few quarters, suggesting that bottom-up stock selection and relative value within asset classes should begin to outweigh top-down risk on, risk off trading. The value of diversification from holding a basket of global equities as opposed to taking directional bets on a handful of countries should benefit the risk-adjusted returns for a portfolio more so than it has over the past few years. As a result, we are favoring a much more balanced view than before.

Foreign Developed Equities

During the quarter, the MSCI EAFE (Europe, Australasia, and the Far East) index gained 3.5% in dollar terms. This return was below the return on US equities largely due to the disaster in Japan. Both European and Japanese equities underperformed US equities in local terms. However, the appreciation of the Euro resulted in better

S&P 500 Sectors	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	4.7%	4.7%	21.2%	33.7%	25.8%
Consumer Staples	2.5%	2.5%	10.6%	16.2%	46.6%
Energy	16.8%	16.8%	39.8%	12.4%	59.7%
Financials	3.1%	3.1%	4.0%	-29.5%	-43.0%
Healthcare	5.6%	5.6%	5.1%	13.5%	14.4%
Industrials	8.8%	8.8%	21.9%	4.2%	18.7%
Info. Technology	3.5%	3.5%	11.9%	23.7%	26.9%
Materials	4.5%	4.5%	24.3%	6.5%	39.9%
Telecom. Services	4.9%	4.9%	30.4%	9.5%	26.3%
Utilities	2.8%	2.8%	12.4%	-4.3%	25.9%

USD Total Return

Source: Bloomberg

US Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Russell 1000	6.2%	6.2%	16.7%	9.3%	15.7%
Russell 2000	7.9%	7.9%	25.8%	28.0%	18.0%
Russell 1000 Value	6.5%	6.5%	15.2%	1.8%	7.1%
Russell 1000 Growth	6.0%	6.0%	18.3%	16.4%	23.7%
Russell 2000 Value	6.6%	6.6%	20.6%	21.7%	11.8%
Russell 2000 Growth	9.2%	9.2%	31.0%	33.7%	23.7%

USD Total Return

Source: Bloomberg

Foreign Devlpd. Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P/TSE (Canada)	8.3%	8.3%	26.1%	22.5%	61.3%
FTSE 100 (UK)	4.4%	4.4%	14.1%	-4.9%	12.2%
CAC-40 (France)	11.3%	11.3%	9.4%	-14.1%	6.8%
DAX (Germany)	9.0%	9.0%	20.0%	-3.3%	37.9%
SMI (Switzerland)	2.4%	2.4%	9.4%	4.3%	28.6%
S&P/ASX 200 (Australia)	4.9%	4.9%	18.3%	22.6%	81.4%
Nikkei 225 (Japan)	-5.0%	-5.0%	1.1%	-1.1%	-12.5%

USD Total Return

Source: Bloomberg

performance for European equities, with stocks in Greece rallying the most. As was the case globally, the quarter's best sector was Energy, which benefited from an unexpected rally in commodity prices.

Equities within the EAFE index currently have much more attractive valuations than US or emerging market equities. Their attractiveness has increased substantially over the past year, particularly since many global investors are underweight Europe and Japan. We recommend finding strong managers and returning to long-term asset allocation weights. The benefits of a well balanced portfolio should increase as correlations continue to break down. The shift away from top-down risk on, risk off trading to bottom-up stock selection should become much more visible over the next year. This may be a headwind for investors allocating to select countries, basing their decisions heavily on macroeconomic headlines.

We believe that there are a number of very exciting opportunities in Japan despite the hurdles the country has faced and is likely to face going forward. Generally speaking, many Japanese companies have minimal direct exposure to the impacted area¹³ and have very strong balance sheets, with minimal debt and strong cash flows. Additionally, many have repositioned their business structures to benefit from Asia's faster-growing emerging markets to overcome the slow growth environment in Japan.¹⁴ As a result, we have increased our exposure to select Japanese equities.

Similarly, macroeconomic fundamentals and contagion headlines have generally depressed European equity valuations. As a result, there are some very attractive opportunities in companies with strong balance sheets and globally diverse revenue streams. While we have taken some profits in our Europe exposure due to the rapid appreciation of the Euro, we continue to believe that there are a number of very attractive opportunities within the region.

In US dollar terms, the largest threat to returns is the potential for the Yen and Euro to depreciate relative to the US Dollar. While we believe that weaker currencies could boost business activity for equities in Japan and Europe, equity returns may not be sufficient to offset currency swings due to sentiment. While this is not our base case, it is certainly a threat that deserves continued close attention. The second largest threat is a pronounced slowdown in emerging market economies. With subpar economic growth in large developed regions, including the US, Europe, and Japan, a sharp slowdown in emerging market economies could have a meaningful negative impact on our equity allocations, particularly since we have intentionally allocated to companies with globally diverse revenue streams.

Emerging Market Equities

During the quarter, the MSCI Emerging Market index gained 1.9%. The return was lower than the returns on US and EAFE equities. Exposure to Russia, which benefited from currency appreciation and from higher oil prices, contributed the most to performance. Notably, most country returns were below the return on US equities in both local and USD terms. As was the case globally, the quarter's best sector was Energy, which benefited from an unexpected rally in commodity prices.

As expected, emerging market equities underperformed US equities on an absolute and risk-adjusted basis. However, the speed of the underperformance was unexpected. The divergence in valuations has shrunk relative to historic standards. Over the next few months, we may see EM equities perform more in line or even begin to outperform US equities. As a result, we recommend returning portfolio weights back to long-term asset allocation targets.

However, we do not recommend an overweight to emerging market equities for a number of reasons, including our expectations of increased volatility over the next few quarters. While quantitative easing in the US is likely to continue to weaken the value of the dollar versus emerging market currencies, US monetary policy is likely to become less accommodative in the second half of this year. Additionally, the weakness of the US Dollar has resulted in increased inflationary pressures within EM, which may or may not ease. Emerging market economies that have stronger currencies may find it difficult to continue to grow at the same pace as they have over the past decade, as slower export growth may

MSCI EAFE	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	-0.6%	-0.6%	15.7%	-0.5%	7.8%
Consumer Staples	0.5%	0.5%	11.1%	7.9%	59.7%
Energy	11.1%	11.1%	16.8%	6.1%	27.5%
Financials	4.6%	4.6%	4.2%	-27.4%	-25.6%
Healthcare	2.4%	2.4%	5.6%	6.8%	13.8%
Industrials	5.4%	5.4%	20.3%	1.4%	23.9%
Info. Technology	-1.1%	-1.1%	1.4%	-11.9%	-15.7%
Materials	1.7%	1.7%	17.4%	-0.2%	48.3%
Telecom. Services	8.7%	8.7%	21.8%	9.3%	55.8%
Utilities	0.4%	0.4%	0.2%	-21.3%	22.8%

USD Total Return

Source: Bloomberg

Emerging Market Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Bovespa (Brazil)	1.0%	1.0%	6.5%	20.8%	141.3%
MICEX (Russia)	15.6%	15.6%	31.1%	-5.1%	40.3%
BSE SENSEX 30 (India)	-4.9%	-4.9%	13.4%	16.4%	84.3%
Shanghai SE (China)	4.9%	4.9%	-0.1%	-5.5%	197.1%
KOSPI (South Korea)	5.7%	5.7%	28.4%	15.4%	47.4%
TAIEX (Taiwan)	-4.0%	-4.0%	22.6%	17.5%	75.4%
FTSE/JSE (South Africa)	-1.6%	-1.6%	23.7%	42.7%	65.7%
IPC (Mexico)	0.9%	0.9%	18.2%	13.4%	94.2%

USD Total Return

Source: Bloomberg

be only partially offset by increased domestic activity. If these risks are ignored, our 2011 prediction concerning EM bubble headlines appearing later in the year may become more likely to occur. If these risks are properly discounted in emerging market equity valuations or if these risks subside, we intend to strategically increase our emerging market equity targets to be more in line with global equity weightings.

MSCI EM	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	1.6%	1.6%	31.8%	53.5%	74.9%
Consumer Staples	-1.5%	-1.5%	24.4%	49.2%	115.5%
Energy	11.9%	11.9%	24.0%	4.1%	57.1%
Financials	0.7%	0.7%	15.1%	20.2%	63.3%
Healthcare	-5.0%	-5.0%	7.4%	47.9%	62.2%
Industrials	-3.2%	-3.2%	19.7%	-9.0%	58.9%
Info. Technology	-1.9%	-1.9%	14.6%	24.6%	34.2%
Materials	2.8%	2.8%	19.6%	10.5%	109.3%
Telecom. Services	1.5%	1.5%	14.5%	-6.8%	71.8%
Utilities	2.3%	2.3%	9.0%	15.3%	72.8%

USD Total Return

Source: Bloomberg

World Fixed Income Review and Outlook

	Performance		USD YTM Change	USD Duration Change	USD Avg. Quality		USD Avg. Coupon	
	USD	LCL			12/31/10	3/31/11	12/31/10	3/31/11
World Government Bonds	0.7%	-0.7%	0.27	-0.02	AA+	AA+	2.95	2.97
United States	-0.2%	-0.2%	0.18	0.01	AAA	AAA	2.86	2.84
Canada	1.6%	-0.6%	0.16	-0.31	AAA	AAA	3.68	3.63
Australia	2.7%	1.8%	-0.16	-0.21	AAA	AAA	5.65	5.61
Japan	-2.7%	-0.6%	0.10	0.04	AA	AA-	1.39	1.39
Malaysia	2.2%	0.4%	0.12	0.01	A+	A+	4.01	4.05
Singapore	3.3%	1.6%	-0.22	-0.11	AAA	AAA	3.01	2.94
European Monetary Unit	4.5%	-0.9%	0.44	-0.09	AA+	AA+	4.09	4.07
Austria	3.8%	-1.9%	0.50	-0.17	AAA	AAA	4.15	4.13
Belgium	5.3%	-0.5%	0.25	0.01	AA+	AA+	4.33	4.39
Finland	3.5%	-2.2%	0.69	-0.11	AAA	AAA	3.87	3.79
France	3.7%	-1.9%	0.55	-0.26	AAA	AAA	4.04	4.00
Germany	3.4%	-2.3%	0.65	-0.10	AAA	AAA	3.68	3.59
Ireland	-0.2%	-5.7%	2.22	0.02	A	A-	4.67	4.73
Italy	6.4%	0.6%	0.07	0.03	A+	A+	4.36	4.32
Netherlands	3.4%	-2.3%	0.68	0.05	AAA	AAA	3.80	3.79
Portugal	-3.8%	-9.1%	2.61	-0.53	A-	BBB	4.41	4.48
Spain	8.2%	2.2%	-0.28	-0.07	AA	AA	4.28	4.31
Denmark	2.9%	-2.6%	0.56	-0.53	AAA	AAA	4.41	4.41
Norway	4.8%	-0.3%	0.29	-0.26	AAA	AAA	5.29	5.28
Poland	4.4%	0.3%	0.31	-0.12	A	A	4.10	4.24
Sweden	6.9%	0.3%	0.18	-0.08	AAA	AAA	4.75	4.69
Switzerland	1.1%	-0.8%	0.18	-0.20	AAA	AAA	3.44	3.44
United Kingdom	1.6%	-0.8%	0.32	0.14	AAA	AAA	4.52	4.44

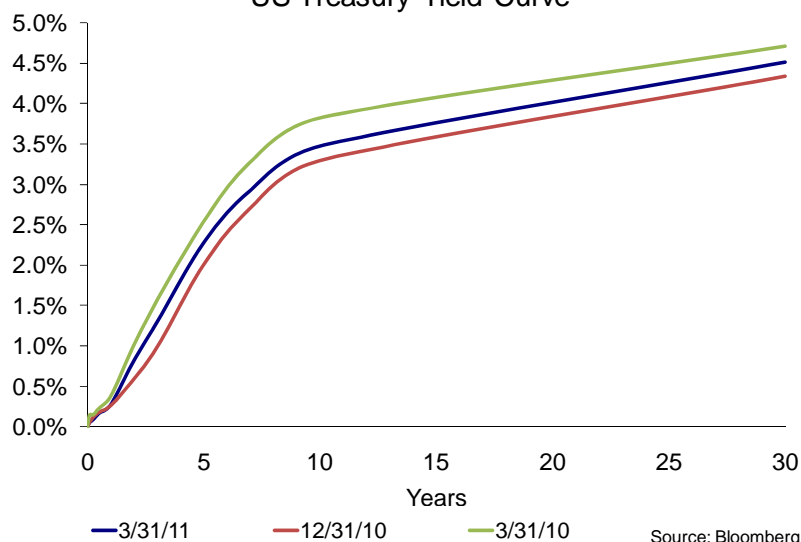
Source: Bloomberg, Citigroup YieldBook

US Fixed Income

During the quarter, US Treasury yields rose across all maturities. Yields are now higher than they were a year ago. Within the Investment Grade universe, the decline in US Treasury bonds was offset by strong total returns in Government Sponsored bonds, Collateralized debt, and Corporates. The best performing securities were within Financials, Transportation, Energy, and Manufacturing. High yield remained resilient as investors continued to seek yield.

As we have discussed over the past few quarters, we believe that Treasury yields are just way too low and are unlikely to decline much further than these levels due to the relative attractiveness of long-term real returns. In addition, higher yields are warranted as the economy recovers, the risks of another downturn subside, and the demand for financing increases. When the Fed is no longer a structural buyer of Treasuries, government bonds are likely to experience further pressure.¹³ The largest fixed income mutual fund manager, Bill Gross, has finally caught up with us. Most recently, he reduced all direct Treasury exposure in his largest fund, despite having a benchmark with over 40% exposure to Treasuries.¹⁵ Despite our view of higher Treasury rates to come, we reiterate that yield volatility is likely to be lower than expected.

US Treasury Yield Curve



Source: Bloomberg

High yield has continued to perform exceptionally well given wide spreads, improving fundamentals, and strong fund flows. While we believe that relative yields are very attractive, absolute yields are not particularly compelling. If fundamentals for a company were really that great, the company's debt would be classified as Investment Grade rather than High Yield. In addition, due to strong fund flows, there has been an increasing number of covenant-lite loans re-entering the market. This is in line with our 2011 prediction of true risk becoming severely underpriced as attention focused on potential and trailing returns. As a result, we have kept a modest High Yield exposure despite our view that this segment of the fixed income universe may add value in the face of higher benchmark rates. On a more optimistic note, the maturity wall from 2012-2014 that existed from debt originated at the peak of the credit boom has been significantly reduced due to refinancing; this includes leveraged-buyout debt.¹⁶

Foreign Developed Fixed Income

Performance was mixed regionally within foreign developed fixed income. Australia, New Zealand, and non-Japan developed Asia generated strong returns, while Japanese bonds were down. European debt generally declined in local terms, but generated a healthy return in USD terms. Within Australia, Collateralized and Corporate debt gained the most, while in non-Japan developed Asia, Singapore bonds outperformed. In Europe, the largest declines were in long duration Government and Government Sponsored debt, particularly Portuguese and Irish bonds.

US credits have generally outperformed European credits, largely due to concerns regarding the European sovereign crisis and the potential policy mistake of rate hikes by the ECB. While we believe that these issues warrant a higher premium for fixed income within Europe, we believe there may be potential for European credits to begin outperforming US credits should rhetoric over restructuring certain sovereign obligations intensify.¹⁷ However, we would prefer to be late to this game than chance our clients' assets, especially given the long-term fundamental sovereign flaws that have yet to be materially remedied. As a result, we continue to focus our European exposure on high quality securities that are either systemically important or have a substantial amount of government support. In addition, we continue to derive a sizable amount of our European exposure from non-European Monetary Unit countries.

Emerging Market Fixed Income

Performance was strong for emerging market fixed income securities. Nearly every broad segment was up, including Brady Bonds and Eurobonds, Sovereigns and Corporates, and Investment Grade and High Yield debt. Additionally, returns were boosted by a decline in the US Dollar.

With regards to Emerging Market Sovereign debt, Investment Grade outperformed High Yield, and Latin American bonds outperformed non-Latin American securities, but there was a substantial amount of dispersion in returns. Bonds from the Ivory Coast, Ecuador, and Georgia gained the most, while bonds from Belarus and Egypt declined the most. The most volatile bonds belonged to the Ivory Coast, Belarus, and Egypt.

With respect to Emerging Market Corporates, High Yield outperformed Investment Grade. Emerging Europe and Africa bonds gained the most and Industrials was the best performing sector. The best performing countries were Egypt and Barbados, while Bahrain declined the most. The most volatile bonds were in Egypt, Bahrain, and Kuwait.

Emerging market bonds have exhibited a remarkable resilience despite political instability, inflation concerns, the impact from Japan's natural disasters, and European sovereign stress. This has been on the back of strong fundamentals relative to high-deficit developed world counterparts. Despite sharp fund flows into this asset class, we may explore increased exposure to this asset class as geopolitical risks ease and inflationary pressures fade, both of which should reduce the discount rate used in valuations.

Commodities Review and Outlook

Commodities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
*Energy	15.4%	15.4%	16.0%	-43.9%	-33.1%
**NYMEX Crude Oil	16.8%	16.8%	27.4%	5.1%	60.2%
**NYMEX Natural Gas	-0.4%	-0.4%	13.4%	-56.5%	-39.1%
*Precious Metals	4.4%	4.4%	38.0%	60.3%	145.3%
**COMEX Gold	1.2%	1.2%	29.2%	57.1%	147.3%
**Silver Composite	21.8%	21.8%	115.5%	118.5%	227.4%
*Industrial Metals	1.3%	1.3%	13.2%	-8.8%	42.1%
*Agriculture	4.0%	4.0%	70.0%	-2.8%	44.0%
*Livestock	7.4%	7.4%	10.9%	-13.4%	-24.2%

* S&P GSCI Official Close Indices TR

Source: Bloomberg

** Price Change

Oil

During the quarter, heightened geopolitical risk in the Middle East/North Africa and further US Dollar weakness boosted oil prices. While we remain constructive on Energy prices long-term, we believe that oil prices are overextended on a near-term basis. Oil prices have risen beyond fundamental supply and demand factors, primarily due to fears of political instability spreading to larger oil producing nations. This argument is supported by emerging signs of demand destruction in the US, elections in Nigeria, and a potential ceasefire in Libya.¹⁷ There exists further downside risk should the US Dollar recover as the Fed becomes less accommodative.

Oil Index
5-Years Ending 3/31/11



— Oil Index

Source: Bloomberg

Gold

As we stated in July, we clearly see the benefits of having some exposure to gold given long-term inflationary pressures, increased risk in the global economy, and mounting pressures on the US Dollar. However, signs of rampant inflation are still not visible in the developed world. The US Dollar has come under pressure, but downside risks to the global economy are easing. Over the past nine months, gold has continued to rise and is trading near all-time highs as of the time of this writing. Meanwhile, our most preferred asset class, US equities, has outperformed over the same time period. In fact, US equities have outperformed every quarter since our Q2.2010 commentary. While we suspect that this divergence may shrink over the next few quarters as volatility increases in the equity markets, we continue to stress the importance of a disciplined long-term asset allocation policy, particularly since we are seeing correlations between and amongst equities and commodities continue to decrease.

Currencies Review and Outlook

FX Rates	3/31/11	12/31/10	9/30/10	6/30/10	3/31/10	12/31/09
EURUSD	1.42	1.34	1.36	1.22	1.35	1.43
USDJPY	83.13	81.12	83.53	88.43	93.47	93.03
GBPUSD	1.60	1.56	1.57	1.49	1.52	1.62
USDCAD	0.97	1.00	1.03	1.06	1.02	1.05
AUDUSD	1.03	1.02	0.97	0.84	0.92	0.90
USDCHF	0.92	0.94	0.98	1.08	1.05	1.04
USDMXN	11.90	12.34	12.59	12.94	12.37	13.09

Source: Bloomberg

During the quarter, the US Dollar continued to depreciate against most currencies, with the Japanese Yen as a notable exception. The decline was the result of the continuation of a number of factors. First, increasing signs of a global economic recovery supported risk-taking activity, which typically weighs on safety currencies such as the US Dollar, Japanese Yen, and the Swiss Franc. Second, the Fed's quantitative easing program continued to pump sizable liquidity into the market, further supporting risk-taking behavior such as "carry trading." Third, US fiscal deficit headlines further stimulated questions concerning the long-term viability of the US Dollar as the world's reserve currency. While we continue to believe in the long-term devaluation of the US Dollar versus a basket of emerging market currencies, we believe that developed world currencies are trading close to the upper range of their near-term bands. The rhythm of US Dollar depreciation may become more volatile should the Fed become more hawkish and the US government's deficit reduction strategy becomes more credible over the next few quarters.

Euro

We continue to believe that the Euro is likely to experience large bouts of volatility due to sentiment shifts. As evidenced by the chart to the right, the daily price change for the Euro remains well above its 2006/2007 range. Presently, we believe that the Euro is gradually becoming overextended to the upside versus the US Dollar for several reasons in addition to the ones mentioned above. First, 2010 growth for the Eurozone was strong, but it was largely on the back of strong German growth. With most countries implementing largely credible austerity measures, the pace of growth may be threatened. Second, the ECB appears to be engaging in activities that would regain its inflation fighting credibility by increasing interest rates despite muted economic growth and by gradually withdrawing short-term liquidity facilities. The interest rate differential and expectations relative to the US Dollar have supported carry trading activity. Third, as mentioned earlier, policymakers introduced a stronger bailout fund aimed at reducing the financing costs for troubled member nations. This strengthened the illusion that European officials have the sovereign debt crisis under control. We believe that the combination of these elements have improved sentiment towards the Euro. As the reality of the fundamental fiscal problems in Europe once

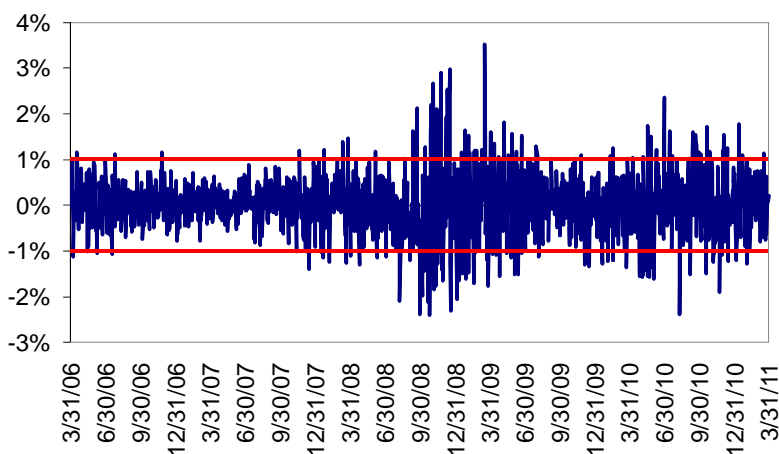
US Dollar Index
5-Years Ending 3/31/11



—US Dollar Index

Source: Bloomberg

EUR Daily Return
5-Years Ending 3/31/11



—EUR Daily Return

Source: Bloomberg

again come to fruition and the US picture improves, we believe that the Euro may weaken versus the US Dollar. As of this writing, this is the contrarian view.

Japanese Yen

Last July, we discussed the difficulty associated with fiscal consolidation of government finances in Japan. We also mentioned how unsustainable the government's debt obligations were. With regards to monetary policy, we believed that the Bank of Japan's battle against deflationary pressures was likely to keep rates near zero. As a result, we forecasted that the Yen would trade in a relatively tight range to the US Dollar. However, the Yen unexpectedly traded beyond that range. Given that our fundamental rationale has not changed, we now take a firmer view that the Japanese Yen is likely to depreciate relative to the US Dollar. This position is strengthened by the fact that the Bank of Japan swiftly initiated a new round of quantitative easing in response to the recent natural disaster, S&P recently downgraded the country's sovereign debt from AA to AA-, and the G7 recently announced to coordinate an intervention policy against the Yen's appreciation. Similar to our view on the Euro, this is the contrarian stance.

Mexican Peso

Economic growth has been strong since the sharp contraction in 2009, largely driven by the recovery in the US, which resulted in a strong rebound in manufacturing exports and an improvement in private consumption and investments in Mexico. However, we expect a moderation in the US economy to weigh on Mexican growth as there still have not been strong reforms in the Mexican economy, in particular labor laws, energy policies, taxation, and education. The economy has also been supported by an appreciation of other emerging market currencies, which have in effect raised the costs of imports for the US. As the global economy recovers, product differentiation may become more crucial for competitiveness and act as a headwind for Mexican exports. With the US quantitative easing program still in place, it is unlikely that the Banxico will raise rates this year. This may result in higher than expected inflation, which may be detrimental to consumers. These factors are likely to weigh on the currency's strength over a multiple year horizon going forward.¹⁸

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