

Summary

Investor Education (Page 3)

- Last quarter, we discussed the importance of goals when planning investments with the desire to assist clients, prospects, and the general public with their long-term needs. This quarter, we want to provide the same audience with a top-level argument for why selecting high caliber fixed income mutual funds is better than trying to create a portfolio by choosing individual fixed income securities.

What We Pinned in 2010 (Page 7)

- Before reviewing what has happened over the past few months in the economy and in the markets of note, we would like to start by taking a look at our own rhetoric. We are pleased to announce that most of our views were on target, despite the unpopular stances we took.

2011 Predictions (Page 9)

- Most people devote substantial amounts of energy talking about what happened. However, we believe that what is going on now and what is likely to happen in the future is much more important. While we do not have a crystal ball, we do have the moxie to take a stance and date our views.

World Economic Review and Outlook

US Economy (Page 10)

- The US economy is currently being supported by a number of very powerful factors, including further monetary easing, fiscal stimulus, and consumer and corporate strength.

Foreign Developed Economies (Page 11)

- 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. At the current pace, it seems inevitable that a painful subdued economic growth environment is likely to last far longer in Europe than in the US.

Emerging Economies (Page 12)

- The emerging market economic growth story remains intact. The largest threat remains inflation. Food prices, which account for over 25% of consumption in emerging markets, double those of developed world consumption, remain the largest threat. As of this writing, we are witnessing the dangers of food inflation in Tunisia and Algeria.

World Equity Market Review and Outlook

US Equities (page 13)

- Although there has been a strong rally over the past few months, we continue to believe that US large cap equities are one of the most attractive investment opportunities currently available anywhere in the world.

Foreign Developed Equities (page 14)

- With regards to Europe, macroeconomic fundamentals and contagion headlines have been a headwind for European equities. As a result, European equities are some of the most attractively valued in the world.
- While we expect US equities to outperform in 2011, we will look for tactical opportunities to rebalance this allocation to long-term targets upon Euro depreciation.

Emerging Market Equities (page 15)

- Emerging market equities have recently underperformed US equities on a risk-adjusted basis. We believe this trend is likely to continue in the near-term given that a substantial amount of optimism is already priced into EM stocks.

World Fixed Income Review and Outlook

US Fixed Income (page 16)

- While Treasury rates have risen over the past few months, we do not believe that they will continue to rise at the same pace. Instead, we expect the pace to moderate and range trade with an upward trend for 2011.

Foreign Developed Fixed Income (page 17)

- The sovereign stresses that Europe has been experiencing are very linked to the credit sector given the high reliance on banks in the region. As a result, there is a direct connection between fiscal tightening and weaker growth. Overall, both sovereigns and corporates are likely to struggle due to funding stress.¹⁰

Emerging Market Fixed Income (page 17)

- Although we prefer equity exposure over fixed income exposure within emerging markets, the emerging market debt story remains intact even though downside risks are gradually rising. Generally speaking, sovereign emerging market credit quality is at historic highs.

Commodities Review and Outlook (page 18)

- Going forward, we believe that investors are likely to increase their distinction between commodities as a result of actual demand and supply factors for physicals. This is like to result in a breakdown of correlations and increase the benefits of diversification.

Currencies Review and Outlook (page 19)

- With the naïve mindset of “everything will work out in the end,” we believe that the US Dollar, Euro, British Pound, and Japanese Yen are likely to be weaker against a basket of minor developed world and emerging market currencies.

Investor Education

Last quarter, we discussed the importance of goals when planning investments with the desire to assist clients, prospects, and the general public with their long-term needs. This quarter, we want to provide the same audience with a top-level argument for why selecting high caliber fixed income mutual funds is better than trying to create a portfolio by choosing individual fixed income securities. We will present this argument in the following format:

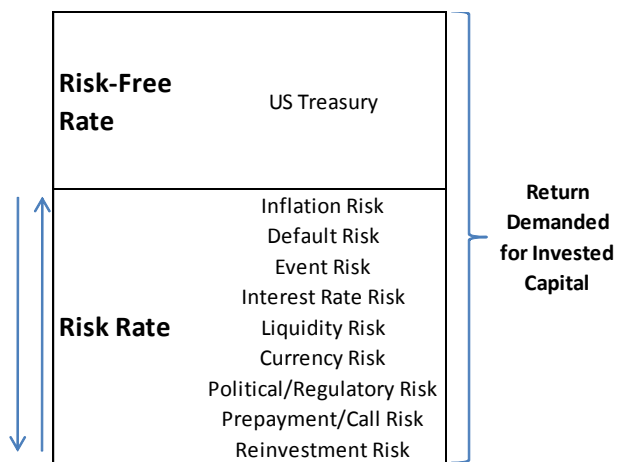
1. Elements that a fixed income security should compensate an investor for
2. What is a bond and what effects bond prices
3. Examples of fixed income securities
4. Pitfalls behind creating a basket of fixed income securities
5. Benefits of a high caliber mutual fund

1. ***Elements that a fixed income security should compensate an investor for***

The total return from a fixed income security should include a risk-free return and a return for the risk undertaken. The risk-free return is essentially the return an investor would realize by investing in a US Treasury. It is the bare minimum return required for an investor to invest their money rather than spend it today, also known as *opportunity cost*. The risk return is a bit more complicated, and is the source of principal volatility. The sources of risk return include the following:

- Inflation Risk – The risk of higher than expected inflation in the future, which would lower the real return experienced by the investor.
- Default Risk – The risk that an issuer is unable or unwilling to pay either a coupon or principal as agreed in the prospectus.
- Event Risk – The risk of something unforeseeable by the public, such as a buyout, explosion, or war.
- Interest Rate Risk – The risk that the risk-free rate changes.
- Liquidity Risk – The risk that the spread between buy offers and ask prices (bid/ask spread) would be wide should the investor need to enter in or exit an investment.
- Currency Risk – The risk of unexpected currency movements.
- Political/Regulatory Risk – The risk of some sort of government action that impacts the real return of an investment, such as changes in tax laws.
- Prepayment/Call Risk – The risk that an issuer opts to pay the principal ahead of official maturity date, eliminating the income stream realized and boosting reinvestment risk.
- Reinvestment Risk – The risk that received income and principal cannot be reinvested at a comparable rate than the rate the initial investment was made.

As new information on the risk rate is received by the market, the premium investors demand for their capital changes, resulting in mark-to-market fluctuations.

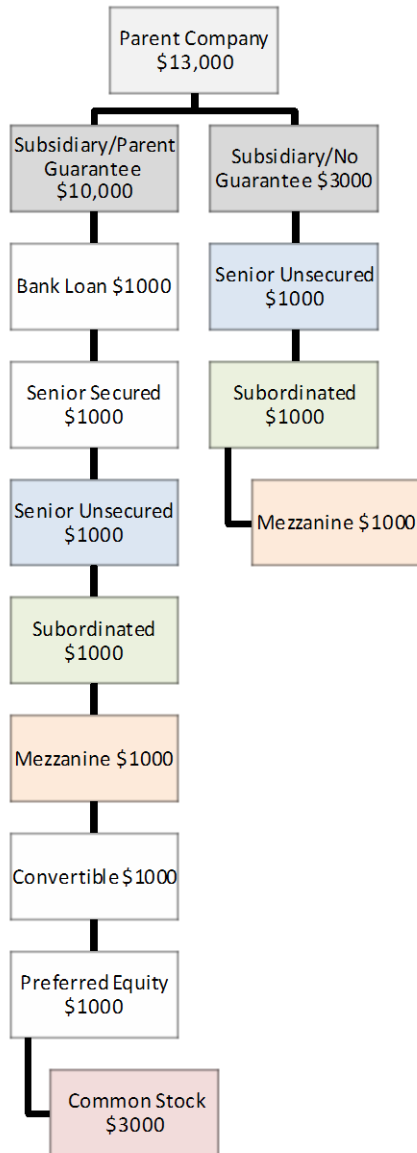


Another determinant for compensation is the position of the fixed income security along the capital structure of a company. The capital structure of a company is essentially a mix of debt and equity financing sources for growth and continuing operations. It outlines the seniority on claims to the company's balance sheet. The capital structure can be structured in a number of ways, and often are complex. The complexity has grown substantially over the years due to creative ways to shield the parent company from the activities of subsidiaries.

Most investors, including many investment managers, do not pay proper attention to the capital structure. An example of a capital structure and potential recovery rate for each layer is shown on the next page. As shown, one security issued by a company could be substantially different from another security in the same company with the same level (without looking at the details) in the firm's capital structure. Investors should demand extra compensation for being lower on the capital structure and/or having no parent company guarantee.

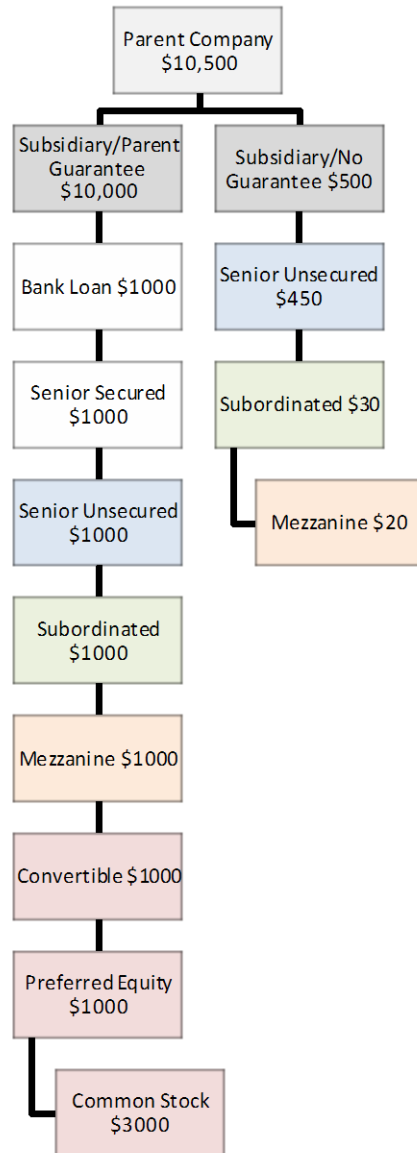
Example A

All departments are profitable, resulting in residual value to shareholders



Example B

Subsidiary with no guarantee fails, but guaranteed debt holders that are lower on the capital structure are still made whole, residual value to shareholders remains in tact



There are a number of other factors which investors need to take a look at before determining if a quoted yield justifies the potential risk of a fixed income security. This includes:

- if the company is allowed to prepay/call certain obligations earlier than expected
- the ability for the company to change periodic coupon payments
- the restrictions in the process to file a lawsuit against the company in the event of default

These elements would further increase the return demanded by investors.

Conversely, there are a number of components that actually protect the investor from default, and thereby reduce the yield that they should demand for an investment. This includes:

- limiting the firm's ability to take on additional debt and requiring the company to maintain certain liquidity ratios
- restricting merger activity that would be detrimental to bond holders
- requiring the company to pledge cash or even pay principal in full should certain adverse events occur

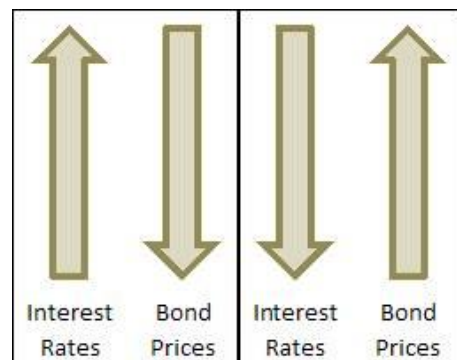
These protective factors are known as covenants. During good times, bond investors neglect the importance of covenants. Many firms take advantage of these periods to issue covenant-lite loans. When there are economic headwinds, these small details can substantially protect investor capital.

2. *What is a bond and what effects bond prices*

The value of a fixed income security today is the "discounted value" of each expected future cash flow. As a result, the factors that determine today's price include the expected coupon/principal payments and associated timing of those cash flows. Mathematically, payments made earlier in the time horizon soften the volatility of a bond, while payments later in the horizon add volatility. As a result, higher coupon paying securities typically have less volatility in a recovering market, but those securities typically carry higher amounts of fundamental risk during a downturn. The higher coupon being paid is a result of investors demanding higher immediate cash flows to soften the impact of default in later years.

The "discount rate" is the rate we discussed in section 1, which is subject to change as new information is available. Two measures of risk relative to potential price movements are "duration" and "convexity."

Duration assesses the sensitivity of today's bond price in comparison to changes in the "discount rate," or more typically known as interest rate. The expected price change is measured by taking the duration and multiplying it by the expected change in yields. For instance, a duration of 7.0 would imply an estimated 7% change in the bond price for every 1% change in interest rates. The higher the duration, the higher the expected price change of a bond. When rates are falling, a higher duration would result in substantially higher appreciation. During a rising rate environment, shorter duration securities may protect investors more than higher duration securities. However, it is very important to note that a parallel shift in interest rates across maturities is uncommon. Shorter term rates can increase while longer term rates can fall, and vice versa. It is also important to note that just because Treasury rates rise, it does not necessarily translate into higher discount rates for every bond. As discussed in section 1, changes in the risk-free rate are only one element of the risk rate. Convexity is a little more complex. Convexity measures the sensitivity of duration to changes in interest rates.



3. *Examples of fixed income securities*

A fixed income security could be structured in many different ways. For instance, it could be a zero-coupon bond, a fixed-rate coupon bond, a floating-rate bond, or an amortizing bond. There may be call options, where the issuer can opt to pay principal ahead of maturity, or put options, where investors can opt to have the principal paid in advance of maturity. The security could be backed by anything with some sort of value, whether it is the government, revenue from highway tolls, a corporate balance sheet, or a pool of mortgages or car loans. Fixed income securities can also have convertibility to equity features. One fixed income security could even be the combination of all of the above.

4. *Pitfalls behind creating a basket of fixed income securities*

One of the main pitfalls behind creating a basket of fixed income securities is focusing only on yield, rating, and maturity. In reality, yields, ratings, and maturities can change depending on the details in the security's prospectus, as discussed before. Moreover, rating agencies are frequently late to report changes in credit quality and investors inadequately measure yield per unit of time (i.e. they may only pick up a small incremental yield for buying a 30-year security versus a 10-year security, but they take on 20 additional years of risk).

Another pitfall is focusing too much on fixed-rate coupon bonds when creating their fixed income portfolio. However, the fixed income universe is very large and very diverse. In rising rate environments, at times, it may be beneficial to have floating-rate securities in your portfolio as opposed to shortening the maturity on fixed-rate coupon bonds. At times, it may be beneficial to hold high quality asset-backed securities as prepayments increase or as they slow in order to maintain high coupons in a low interest rate environment. In any case, there are substantially more structures available than what most investors have exposure to in their fixed income baskets.

The third pitfall is a result of the first two pitfalls. Focusing on just yield and fixed coupon paying securities results on a lack of diversification. As an example, a portfolio may consist of just fixed-rate coupon Financial bonds in the US as they may be the highest rated, highest yielding fixed-rate coupon securities available. This type of portfolio does not take into consideration how cyclical and noncyclical sectors around the world interact with each other. For instance, when the yield curve is steep, it may be a good time to invest in Financials that are able to take advantage of that in their loan books by borrowing short and lending long. At the same time, it may be difficult for an Industrial company to raise much needed capital to finance a 20 year project. As we have witnessed over the past few years, this scenario can change very rapidly.

The fourth pitfall ties into each of the above pitfalls. Media attention to select macroeconomic verbiage often results in rapid shifts in portfolios, without an appropriate amount of research and analysis that fully evaluates those comments. For instance, many experts have been discussing rising rates due to economic growth and inflation. In reaction, many individuals might shorten the duration of their portfolios or even sell fixed income securities all together. However, as we discussed before, not all bonds are designed the same way. Not all structures would be hurt by rising rates. Most likely, rates would not rise across maturities by the same amount. There may even be situations where shortening duration could actually generate additional mark-to-market volatility (if short rates rise rapidly while long rates decline).

5. ***Benefits of a high caliber fixed income mutual fund***

Creating a basket of fixed income securities to outperform a universe is a difficult task when done correctly. It takes a substantial amount of research to safely choose an individual security and optimize the allocation for different market environments with the rest of the basket. At GFG, we encourage investors to allocate to high caliber fixed income mutual fund managers to gain their fixed income exposure. We do this for several reasons:

- Creating and managing a fixed income portfolio requires a substantial amount of time, resources, and experience. The mutual fund basket that we put together has some of the largest teams in place to devote the energy necessary to actively manage a fixed income portfolio.
- The fixed income group of mutual funds we recommend typically holds, in aggregate, over a thousand securities from around the world, across sectors in various different structures. The impact of a default by any one issuer is negligible on overall returns. A number of risk factors from section 1 are diversified away.
- These fixed income mutual funds have the tools, skills, and energy to monitor relatively value amongst securities across maturities. There may be times when AA rated securities are overvalued relative to AAA securities. There may be times when there are more attractive risk-adjusted returns for 7 year maturity securities than for 3 year maturity securities. There may be higher yields in a recovering, but unloved sector. The teams in place monitor market movements and focus on maximizing the return an investor receives per unit of true risk.
- Not only do these mutual funds engage in overall market positioning, but they conduct a substantial amount of fundamental research. As we mentioned before, rating agencies are often slow to report changes in credit quality. The funds we allocate to conduct their own balance sheet analysis and evaluate the health of cash flows the underlying issuers. Quite often, these teams have in depth conversations with policymakers or executive management teams, which the average investor is not privy to, that give them a greater insight into valuations. Their fundamental analysis will also include an evaluation of the health of the entire capital structure, as well as a detailed review of all the covenants.
- In addition to true value recognition in the marketplace, the teams spend a considerable amount of time managing risk. This includes managing duration, monitoring of fund flows, and adapting to changing legal/political environments around the world.
- The teams managing the assets have the relationships in place to ensure best execution, as opposed to trading at wide bid/ask spreads, which at times could make a difference of an entire year's worth of return.
- The structure of the investment vehicle also has daily liquidity, even if underlying securities may take dates to fully liquidate or find bids for.
- The managers also have substantial negotiation powers in the event of a default, when most individual investors have to succumb to the decisions of larger players who may not be looking out for their interests.
- And lastly, we want to stress that mutual funds are not hedge funds. Mutual funds have a substantial amount of regulatory checks and transparency. We fundamentally believe that high caliber mutual funds are the best source of fixed income exposure.

What We Pinned In 2010

Before reviewing what has happened over the past few months in the economy and in the markets of note, we would like to start by taking a look at our own rhetoric. We are pleased to announce that most of our views were on target, despite the unpopular stances we took:

When many individuals feared the chances of a double dip recession, we stated the following:

- ❖ We acknowledge that the pace of the recovery has slowed and is likely to slow further in the future. Still, we remain optimistic that the economy is on a path to recovery. (Q2.2010 Page 2)

When many individuals feared further job losses, we stated the following:

- ❖ With regards to unemployment, we believe that some of jobs will slowly return as many corporations have reduced headcount below minimum operating levels. (Q2.2010 Page 2)

When many individuals feared rampant inflation or deflation, we stated the following:

- ❖ A strengthening dollar and subdued economic growth are likely to keep inflation under control for the time being. (Q2.2010 Page 3)
- ❖ We believe that the threats of significant deflation are minimal and instead believe that there are substantially more inflationary pressures in the long-run. (Q2.2010 Page 3)

When many individuals feared that either Greece or Germany would leave the European Union, we stated the following:

- ❖ There has been some speculation about either Greece or Germany leaving the European Union. We do not believe that either of these outcomes is likely. (Q2.2010 Page 4)

When many individuals feared a sharp pullback in equities, we stated the following:

- ❖ We believe that investors have been looking for reasons to justify a market correction after the strength in equity markets since March 2009. (Q2.2010 Page 6)
- ❖ We believe that high quality firms are still attractive and would generally recommend staying invested through the volatility. (Q2.2010 Page 7)
- ❖ We continue to believe that US large cap equities are one of the most attractive opportunities currently available anywhere in the world. (Q3.2010 Page 9)

When many individuals over-allocated to emerging market equities, we stated the following:

- ❖ As discussed in the US equity segment, many large firms, the ones we have been encouraging our clients to invest in for some time have expanded into emerging markets already and are continuing to do so. As a result, their portfolios already have emerging market exposure that is not clearly labeled as "EM." Some of these developed market equities are assigning cheaper valuations to those EM exposures than direct EM exposure through EM equities. (Q3.2010 Page 10)

When many individuals continued to pump assets into Treasuries, we stated the following:

- ❖ Although we believe that short-rates are likely to remain low for some time, we expect long-rates to gradually rise over time and see little justification for long-dated [Treasury yields] to fall much further. (Q2.2010 Page 9)
- ❖ We do not believe that a new round of quantitative easing would reduce Treasury yields much further... There may be mass disappointment if the Fed fails to meet expectations or even only meets expectations. (Q3.2010 Page 6)
- ❖ Currently, fixed income markets are already pricing in massive amounts of quantitative easing... There is a possibility that investors sell off "on the news" forcing yields up sharply. Once again we take the contrarian view, believing that 10-year Treasury yields are unlikely to fall much further. As discussed before, we believe that yields are likely to realize upward pressure. (Q3.2010 Page 11)

When many individuals feared European sovereign debt exposure, we stated the following:

- ❖ In line with our economic views, we have no exposure to bonds from Greece, Portugal, Ireland, Italy, or Spain in our core strategies. (Q2.2010 Page 10)
- ❖ The German economy is strong and stands to benefit from a falling Euro; as such, German sovereign and corporate bonds constitute a large percentage of our exposure to Eurozone debt. (Q2.2010 Page 10)

When many individuals sold oil, we stated the following:

- ❖ We believe that as evidence continues to mount that the US is not heading into a severe double-dip recession, the price of oil will gradually rise with demand. (Q2.2010 Page 11)

When many individuals were outright short the Euro, we stated the following:

- ❖ Over the next few months, there may be large swings in either direction due to changes in sentiment. (Q2.2010 Page 12)

Other currency views included:

- ❖ Canadian Dollar: Given our views on long-term commodity prices, we expect the Canadian dollar to strengthen in the future. (Q2.2010 Page 13)
- ❖ Australian Dollar: In addition, increased global risk aversion may result in currency weakness as investors flock to safe-haven assets. (Q2.2010 Page 13)
- ❖ Swiss Franc: This has led to an accumulation of high foreign currency reserves, which may become overwhelming, further supporting the appreciation of the franc. (Q2.2010 Page 13)
- ❖ Mexican Peso: Although there is medium term support from the IMF, Banxico needs to engage in a policy to build reserves. Until that happens, volatility is likely to persist, but capital inflows and China's gradual appreciation of the yuan (as Mexico and China compete for the US market) are likely to result in a stronger currency. (Q2.2010 Page 13)

And in all fairness, below are some views that we are still waiting on to occur:

- ❖ We would like to see a more pronounced improvement in financing before making any bullish generalizations on small cap stocks. (Q2.2010 Page 7)
- ❖ We clearly see the benefits of having some exposure to gold given the long-term inflationary pressures, increased risk in the global economy, and mounting pressures on the US dollar. However, signs of rampant inflation are not yet visible in the developed world, and the US dollar appears to be one of the most attractive major world currencies in this environment. In addition, we fear that there may be a bubble slowly building in this market as other investors flock to this commodity based on the same thesis. Our caution builds every time we see a commercial to buy or sell gold on television. Therefore, we have intentionally kept the allocation to precious metals in our core portfolios relatively modest. (Q2.2010 Page 11)

2011 Predictions

Most people devote substantial amounts of energy talking about what happened. However, we believe that what is going on now and what is likely to happen in the future is much more important. While we do not have a crystal ball, we do have the moxie to take a stance and date our views. Before we address our current views, there are two important points to note. First, we are not married to these views and will adapt as new information is available just as we have in the past. Second, while we position our portfolios to benefit from these predictions, we will continue to have considerable protection should we be wrong. That said, let us begin:

- ❖ We expect global growth to surprise to the upside. As evidence mounts for stronger-than-expected growth, we anticipate that fears of a double-dip recession and deflation are likely to disappear completely by year end.
- ❖ Large corporations are likely to start reinvesting their large cash balances, further boosting economic growth and possibly helping to create jobs. This reinvestment is likely to result in increased mergers and acquisitions activity. There may be a few large mergers with downsizing headlines, but hundreds of thousands of jobs are still likely to be created this year.
- ❖ Due to a more balanced US Congress, very little real change may actually come from the federal government. This has and should likely continue to reduce the legislative uncertainty embedded in valuations.
- ❖ Equities may see increased fund flows, while bonds see net fund outflows. This may support equity prices, while adding downward pressure on fixed income securities.
- ❖ “Emerging Market Bubble” headlines are likely to become more visible in the second half of the year.
- ❖ The US dollar is likely to continue to lose value relative to emerging market currencies. The Euro could trade in a wide range relative to the US dollar due to short-term and bandwagon mentality.
- ❖ Commodities are likely to continue rising. Gold may continue to attract funds, but returns are likely to be below most other risk assets. We continue to stress allocating to resources that have real supply and demand constraints, as opposed to fickle investment opportunities.
- ❖ Recovering markets are likely to result in many investors and advisors reducing the quality of their due diligence and research. Financial intermediaries providing low value work could once again be rewarded with high compensations.
- ❖ True risk may be severely underpriced as attention focuses only on potential and trailing returns.
- ❖ Correlations are likely to continue to break down slightly, but a high asset allocation focus may continue to weigh on large distinctions between securities, particularly given the flows to managed future funds and ETFs. The breakdown in correlations is likely to result in fundamentally stronger companies outperforming.
- ❖ Fixed Income yields may rise globally, and as a result, high coupon securities and floating-rate bonds are likely to outperform similar low coupon securities.
 - The volatility in interest rates may be much lower than people fear.
 - Interest rate volatility may be balanced by increases in other risk assets.
 - The largest jolt to interest rates this year is likely to come from the Fed changing the language in their releases from keeping benchmark rates low for an “extended period of time” to more near-term verbiage.
 - This may present a very good buying opportunity for intermediate maturity bonds as markets realize that the verbiage change does not mean this year. Moreover, most investors do not grasp that if short-term rates rise, it does not necessarily translate into an equivalent rise in medium-term and long-term rates.

World Economic Review and Outlook

World GDP	Actual						Forecast/Estimate		
	2004	2005	2006	2007	2008	2009	2010	2011	2012
US	3.60	3.10	2.70	1.90	0.00	-2.60	2.90	3.10	3.20
Canada	3.12	3.02	2.83	2.20	0.53	-2.46	2.90	2.40	2.60
UK	2.80	2.10	2.80	3.00	0.70	-5.00	1.80	2.00	2.10
France	2.50	1.90	2.20	2.40	0.20	-2.60	1.60	1.60	1.85
Germany	1.20	0.80	3.40	2.70	1.00	-4.70	3.60	2.55	2.00
Switzerland	2.53	2.65	3.63	3.65	1.88	-1.93	2.70	1.70	2.20
Australia	3.73	3.23	2.50	4.65	2.58	1.33	3.40	3.60	3.60
Japan	2.78	1.93	2.03	2.35	-1.13	-6.28	4.30	1.40	2.00
Brazil	5.70	3.18	3.97	6.08	5.20	-0.63	7.50	4.45	4.50
Russia	7.20	6.40	8.20	8.50	5.20	-7.90	3.70	4.20	4.10
India	7.25	9.23	9.83	9.50	7.48	6.83	N/A	N/A	N/A
China	10.10	11.30	12.70	14.20	9.60	9.20	10.06	9.05	N/A
South Korea	4.60	4.00	5.20	5.10	2.30	0.20	6.10	4.20	5.00
Mexico	4.10	3.20	5.20	3.30	1.50	-6.10	5.10	3.70	4.05

Current as of 1/21/11

Red = downward revision

Green = upward revision

Source: Bloomberg / Contributor Composite

US Economy

The US economy is currently being supported by a number of very powerful factors, including further monetary easing, fiscal stimulus, and consumer and corporate strength.

Last quarter, we reported how the Federal Reserve signaled that they are likely to institute another round of “quantitative easing” in response to deflation hearsay, muted growth prospects, and the persistently grim employment picture. We stated that we do not believe that a new round of quantitative easing would reduce Treasury yields much further, particularly if the Fed did not announce a program greater than \$1 trillion. And, we noted that there may be mass disappointment if the Fed fails to meet or surpass expectations.

In November, the Fed indeed delivered another round of quantitative easing, or QE2. It launched a \$600 billion Treasury-buying program that would also reinvest proceeds from their previous quantitative easing efforts. As predicted, Treasury yields rose from 2.5% on November 4 to 3.3% by year end, partially due to the tax package signed into law in December, discussed next. To date, the Federal Open Market Committee has focused on purchasing nominal Treasury securities with maturities of 2 to 10 years, along with some longer term securities and Treasury Inflation Protected Securities.¹ Although the size of the program was relatively low, the Fed’s rhetoric to do anything it takes to promote growth and price stability remained strong. We continue to have full faith in the Fed’s ability to execute its goals, even if it requires taking illegal actions like expanding the word “discount” in Section 13(3) and the word “government agency” in Section 14(b) of the Federal Reserve Act to buy \$30 billion of Bear Stearns’ assets or \$1.5 trillion of Fannie and Freddie Mac obligations.²

In December, President Obama signed into law a bipartisan tax package worth over \$850 billion. Some of the highlights of this program include a payroll tax reduction from 6.2% to 4.2%, which is expected to boost household income by \$100 billion. The inheritance tax was reinstated with lower exclusions and higher top tax rates. In 2010, there was no inheritance tax. Going forward, there will be a \$5 million exclusion with a 35% tax on the excess above that number. Business investments will be allowed to be fully expensed in 2011, compared to just 50% in 2010. The 99-week maximum unemployment benefit program was also extended through the end of 2011.³ However, the most important part of this package was a resolution of a previous uncertainty. We suspect that with this resolution, many individuals and businesses that have put investments and expenditures on hold are likely to pump capital into the economy and markets.

Consumers have shown some signs of strength over recent months. Incomes are rising, confidence has been recovering, and consumers are spending. Understandably, spending has been led by high-income households. It will take some time before this trickles down to lower-income households, especially since the impact of the recent recession is still very fresh in people’s minds. Labor demand is rising, and the average work-week is increasing. This suggests that the level of “underemployment” is likely to be declining. Underemployment basically refers to those individuals that are technically employed but underpaid and/or are working part-time involuntarily. Moreover, financial obligations and debt costs have declined as a percentage of household income, potentially setting the stage for increased discretionary spending or more stable household balance sheets. Increased discretionary spending would provide a boost to economic

growth, but increased savings would pave the way for much cleaner and healthier growth, as discussed in previous quarters. One of the biggest headwinds on consumers remains house prices, which are still under severe amounts of pressure. Another large headwind remains employment, which we expect may gradually recover.^{1,4} The positive momentum in payrolls may attract a number of previously discouraged labor force participants to begin to search for jobs again. This may keep the unemployment rate elevated even though jobs are being created. Furthermore, as we have discussed before, there has been a structural change in the US and many jobs that have been lost are not returning. The extension of the 99-week maximum unemployment benefits program is likely to delay the recovery in employment as many individuals may prefer to receive federal aid than work.

Corporations are also looking strong. Manufacturing, which was one of the primary segments to lead the economy out of the recession, remains in expansionary territory as the restraint on consumer and business inventory demand eases. The momentum of this expansion has slowed over recent months but is likely to be a contributor to growth going forward. Additionally, a weakening dollar, faster emerging market growth, and easing of trade restrictions should boost exports.⁵ Another promising strength for corporations is the potential for multinationals to repatriate over \$1 trillion in offshore earnings at low tax rates, similar to the tax holiday they capitalized on in 2004. Some have already found legal ways of avoiding a substantial amount of repatriation taxes.⁶

Foreign Developed Economies

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. At the current pace, it seems inevitable that a painful subdued economic growth environment is likely to last far longer in Europe than in the US.

The latest round of headlines included Ireland's troubles. The root of the nation's problem revolves around its domestic banking system, which at its peak was five times the size of the economy.⁷ In 2008, in the midst of the global economic downturn, the government had announced a blanket guarantee of deposits and bank borrowing, making the banking sector's debt an unsupportable government liability. During the quarter, Ireland requested support from the European Financial Stability Mechanism/European Financial Stability Facility (EFSM/EFSF), the International Monetary Fund (IMF), and bilateral loans from the United Kingdom, Sweden, and Denmark. Ireland requested €67.5 billion in aid from these sources while using €17.5 billion of its own resources, a total of €85 billion. To assure lenders that the government would be able to repay these facilities, the government announced a series of fiscal consolidation programs to increase tax revenues by at least €1.4 billion, reduce expenditures by at least €2 billion, and eliminate at least €1.8 billion in planned public capital expenditures in 2011. These programs include reducing the minimum wage, widening the scope of the "inability to pay clause," reducing unemployment and social assistance benefits, and increasing the state pension age. With regards to the root domestic banking problem, they plan to recapitalize, deleverage, and reorganize banks. In addition, they intend to share potential losses with subordinated debt holders. In an effort to mitigate potentially higher borrowing costs for consumers and individuals, the Irish government intends to enhance banking competition by further opening markets to foreign banks.⁷ This bailout round proved that the Eurozone is prepared to provide liquidity faster to member nations via the newly established EFSM than it was with the Greece situation a few quarters ago.

While most market participants believe that the fiscal policy tightening programs in European countries with large deficits occurring at the moment is credible,⁴ we do not. It is not easy to increase revenue and cut spending in a recessionary environment. Households are hurting, and there is only so much pain that the workforce is willing to deal with before pushing back, particularly when that pain is transferred from the banking sector. Moreover, as we have previously discussed, tighter fiscal policies in a fragile economic recovery could result in another downturn.

The European Union suffers from a number of problems. At the core is the previous access to substantially subsidized capital costs and the lack of a centralized fiscal authority. The formation of the European Union reduced the borrowing costs for small, poorer economies that were very sensitive to even small changes in the global economy. The previously high lending rates these countries paid compensated investors for the higher risks and volatility. Lower financing costs resulted in corporations, consumers, and governments overindulging credit lines and overspending. As a result, a recipe for disaster was broiled with no centralized fiscal authority to manage systemic revenues and costs. To this date, a centralized fiscal authority does not appear feasible given a lack of centralized political/military authority to enforce laws and Europe's immensely diverse economies, political systems, and cultures. Nevertheless, Germany seems to be making some power moves, trading financial benefits for policy influence. Before the end of the European crisis, Germany is likely to become stronger, in terms of both economic growth and political influence in the European Union.⁸

While we expect Germany to experience above average economic growth, there may be sharp dislocations in the rest of Europe. European countries such as France and Italy may have muted growth, and troubled nations like Portugal, Ireland, Greece, and Spain may have below average growth.⁴ With Greece and Ireland already in the headlines, we expect that the next country to receive bailout attention is Portugal. Spain may dodge extreme funding pressures given its size and systemic importance coupled with central banks around the world trying to weaken their currencies against major developed world currencies. Japan and China, both of which are also trying to expand their political influence, have already shown signs that they are more than willing to step in to divert a disaster.⁹

Emerging Economies

The emerging market economic growth story remains intact. The largest threat remains inflation. Food prices, which account for over 25% of consumption in emerging markets, double those of developed world consumption, remain the largest threat. As of this writing, we are witnessing the dangers of food inflation in Tunisia and Algeria. Emerging market interest rates have been on the rise recently but remain below their 2006-07 levels despite above average inflation. Central banks have been slow to combat inflation out of fear that their currencies would appreciate beyond a manageable pace relative to the US dollar and other major export targets.⁴ However, over the past several months, countries such as Korea, Thailand, Taiwan, China and Brazil have taken measures to restrict capital inflows. China, Hong Kong, and Singapore have even taken measures aimed at dampening a potential real estate bubble.¹⁰

With regards to Mexico, manufacturing activity led recovery throughout 2010. The momentum generated appears to be filtering through to improved employment conditions and some increased domestic demand. Mexican growth should be supported by the recent US tax package. In addition, the country's skilled labor force, banking credit expansion, and infrastructure project pipeline should provide some additional tailwind. Moreover, potentially higher energy costs and fiscal headwinds abroad may present a number of opportunities for the country. However, drug-related violence, lack of meaningful structural reforms, and oligopolies remain long-term problems that need to be resolved. If the economy continues to expand at strong rates, politicians may be blinded from addressing some much needed reforms.⁴

World Equity Market Review and Outlook

Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P 500	10.8%	15.1%	15.1%	-8.3%	12.0%
MSCI EAFE	6.7%	8.4%	8.4%	-18.2%	16.1%
MSCI EM	7.4%	19.0%	19.0%	-0.5%	83.6%

USD Total Return

Source: Bloomberg

US Equities

During the quarter, the S&P 500 TR gained 11.3%, bringing 2010 returns to 15.1%. Generally speaking, small caps beat large caps, while growth stocks beat value stocks. The quarter's best sectors were Energy and Materials, while Consumer Discretionary and Industrials outpaced the overall market for the year.

Although there has been a strong rally over the past few months, we continue to believe that US large cap equities are one of the most attractive investment opportunities currently available anywhere in the world.

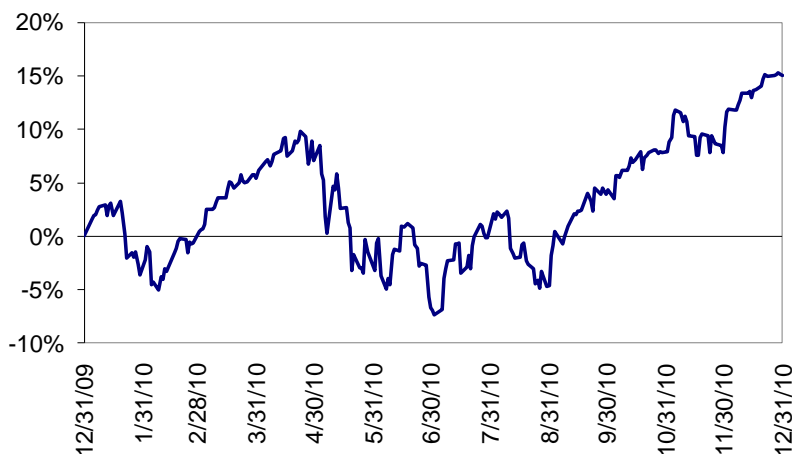
As we have previously discussed, most portfolios are underweight equities despite the necessary return requirements for individuals, underfunded pensions, and endowments. The fund flows from rebalancing to necessary targets is likely to provide a healthy tailwind for valuations.

In addition, large cap equities have a substantial amount of cash on their balance sheets. As an example, the thirty companies in the Dow Jones Industrial Average index have over \$1 trillion cash in aggregate on their balance sheets earning close to no returns. Meanwhile, the companies in the S&P 500 have over \$2 trillion.¹¹ These companies are likely to continue to return earnings back to shareholders in the form of increased dividends, share buybacks, and/or use resources to grow organically and through acquisitions. Consequently, mergers and acquisitions may also be a support for some small cap stocks in the near-term.⁴

Generally speaking, most equities factor in a substantial amount of pessimism, including weak earnings growth, low dividend growth rates, and rapidly rising interest rates.¹¹ This pessimism is likely to subside as the economy recovers. Moreover, large multinationals also have significant exposure outside of the US, including emerging markets. The value of this exposure is priced lower than direct emerging market exposure, further supporting our view that US large cap equities are the best place to invest.

Furthermore, early last year many individuals cited that corporate profits are only likely to look attractive because they are coming from depressed 2009 levels and that revenue growth is still a challenge. They stated that a substantial amount of profit growth came from cutting costs, including labor. Indeed, productivity has improved as companies seized

S&P 500 Total Return
1-Year Ending 12/31/10



— S&P 500 Total Return

Source: Bloomberg

S&P 500 Sectors	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	12.8%	27.8%	27.8%	20.2%	23.7%
Consumer Staples	6.1%	14.1%	14.1%	10.9%	45.3%
Energy	21.5%	20.5%	20.5%	-10.7%	49.2%
Financials	11.6%	12.2%	12.2%	-41.2%	-42.9%
Healthcare	3.6%	2.9%	2.9%	-4.9%	9.7%
Industrials	11.8%	26.7%	26.7%	-7.9%	16.9%
Info. Technology	10.3%	10.2%	10.2%	1.3%	27.8%
Materials	19.2%	22.3%	22.3%	-1.2%	44.0%
Telecom. Services	7.3%	19.0%	19.0%	-9.9%	37.8%
Utilities	1.1%	5.5%	5.5%	-16.2%	21.1%

USD Total Return

Source: Bloomberg

US Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Russell 1000	11.2%	16.1%	16.1%	-6.9%	13.8%
Russell 2000	16.3%	26.9%	26.9%	6.8%	24.6%
Russell 1000 Value	10.5%	15.5%	15.5%	-12.7%	6.6%
Russell 1000 Growth	11.8%	16.7%	16.7%	-1.4%	20.3%
Russell 2000 Value	15.4%	24.5%	24.5%	6.7%	19.1%
Russell 2000 Growth	17.1%	29.1%	29.1%	6.7%	29.5%

USD Total Return

Source: Bloomberg

the opportunity to use the recession as justification to cut massive amounts of overhead. This overhead may remain muted as the massive slack in the labor market keeps wage growth relatively low. Corporate financing costs are also likely to continue to reduce a firm's overall operating costs as older debt matures and is rolled over with cheaper interest payments, even if yields continue to rise.¹¹ That said, as shown in the graph to below, US companies have been steadily growing revenues this whole time.

Revenue Growth	Q-4 (A)	Q-3 (A)	Q-2 (A)	Q-1 (A)	Q (A)	Q+1 (E)	Q+2 (E)	Q+3 (E)	Q+4 (E)
S&P 500	9.9%	11.7%	9.5%	8.6%	8.6%	6.5%	7.2%	7.8%	6.0%
> Energy	5.7%	32.6%	26.6%	16.9%	50.9%	20.1%	20.0%	22.4%	11.1%
> Materials	1.8%	22.4%	23.4%	16.9%	10.6%	12.5%	11.1%	9.3%	8.9%
> Industrials	-3.7%	1.3%	5.4%	7.9%	2.5%	6.3%	6.5%	5.8%	4.6%
> Consumer Discretionary	3.2%	9.0%	8.7%	4.1%	7.7%	4.6%	4.6%	5.7%	5.7%
> Consumer Staples	3.1%	5.4%	4.2%	3.6%	-5.9%	5.0%	5.1%	6.0%	5.1%
> Health Care	12.0%	10.9%	9.5%	8.1%	10.2%	4.8%	4.7%	5.2%	3.9%
> Financials	74.7%	12.4%	-1.1%	4.2%	1.8%	-3.1%	0.8%	1.8%	5.6%
> Information Technology	11.4%	21.4%	22.7%	21.2%	23.3%	10.8%	8.7%	7.7%	7.4%
> Telecommunication Services	3.9%	2.2%	1.7%	1.5%		1.8%	2.8%	1.7%	1.9%
> Utilities	-9.1%	1.3%	2.3%	8.9%	-4.1%	3.3%	8.2%	7.8%	0.6%

Current as of 1/24/11

Source: Bloomberg

Over the past few years, correlations between stocks have been relatively elevated. This has been partially due to the "risk-on, risk-off" trade that many investors have been playing. In addition, large capital flows to managed futures funds and exchange traded funds have resulted in proportionate capital flows across the board. As mentioned previously, we expect that in 2011 these correlations are likely to break down slightly to more normalized levels, creating an environment for fundamentals to outweigh beta chasing. The high quality names that dragged on relative performance for many fundamentally oriented managers may shift from being a headwind to becoming a tailwind.

Foreign Developed Equities

During the quarter, the MSCI EAFE (Europe, Australasia, and Far East) index gained 6.7%, bringing 2010 returns to 8.4% in dollar terms. As expected, these returns were well below the returns on US and emerging market equities. For the year, the best performing major countries were those that experienced strengthening currencies, such as Canada, Australia, and Switzerland. Meanwhile, the best performing sectors were procyclical, including Industrials, Consumer Discretionary, and Materials.

With regards to Europe, macroeconomic fundamentals and contagion headlines have been a headwind for European equities. As a result, European equities are some of the most attractively valued in the world. Similar to US corporations, many firms are likely to experience increased profits but to a smaller degree given the reduced revenue growth potential.¹¹ Earnings performance over the past few months has been positive, especially the quality of earnings. Large cap companies

are likely to lead the market given their exposure to non-European sources of revenue.¹² As a result, while we expect US equities to outperform in 2011, we will look for tactical opportunities to rebalance this allocation to long-term targets upon Euro depreciation.

Foreign Devlpd. Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P/TSE (Canada)	13.3%	25.0%	25.0%	6.1%	60.3%
FTSE 100 (UK)	6.0%	9.1%	9.1%	-18.1%	16.9%
CAC-40 (France)	1.1%	-6.3%	-6.3%	-29.8%	9.0%
DAX (Germany)	8.1%	7.4%	7.4%	-22.7%	43.3%
SMI (Switzerland)	7.0%	12.0%	12.0%	-0.6%	34.9%
S&P/ASX 200 (Australia)	10.9%	17.3%	17.3%	4.7%	84.6%
Nikkei 225 (Japan)	11.6%	11.4%	11.4%	-3.0%	-1.8%

USD Total Return

Source: Bloomberg

MSCI EAFE	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	9.1%	19.9%	19.9%	-9.6%	18.5%
Consumer Staples	3.9%	13.1%	13.1%	3.5%	67.9%
Energy	10.2%	1.5%	1.5%	-14.7%	23.3%
Financials	1.6%	-1.0%	-1.0%	-37.8%	-20.3%
Healthcare	2.6%	2.0%	2.0%	-1.5%	18.5%
Industrials	10.6%	20.8%	20.8%	-11.4%	30.6%
Info. Technology	10.8%	14.7%	14.7%	-23.0%	-7.6%
Materials	17.9%	18.2%	18.2%	-5.3%	65.9%
Telecom. Services	2.4%	7.2%	7.2%	-14.9%	43.8%
Utilities	2.4%	-4.1%	-4.1%	-27.1%	35.9%

USD Total Return

Source: Bloomberg

Emerging Market Equities

During the quarter, the MSCI Emerging Market index gained 7.4%. Returns were lower than US equities. For the year, emerging market equities gained 19.0%. The largest contributions came from India and Russia. Notably, the Shanghai SE, a capitalization-weighted index that tracks the price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange, was negative for the year. Shares within Consumer Discretionary and Consumer Staples were the largest gainers for the year given the increasing amount of middle class consumers within the emerging markets.

Emerging market equities have recently underperformed US equities on a risk-adjusted basis. We believe this trend is likely to continue in the near-term given that a substantial amount of optimism is already priced into EM stocks. Quantitative easing in the US is likely to weaken the value of the dollar versus emerging market currencies. The decline in the US dollar is likely to further increase inflationary pressures within EM. This may create a very difficult headwind for nations unable or unwilling to tighten their monetary policy. In addition, those that are willing to do so may stem growth.¹³ Therefore, we continue to keep our EM exposure relatively modest, in favor of US equities.

Emerging Market Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Bovespa (Brazil)	1.8%	5.9%	5.9%	15.9%	189.7%
MICEX (Russia)	17.4%	22.5%	22.5%	-26.2%	62.0%
BSE SENSEX 30 (India)	3.0%	24.0%	24.0%	-7.2%	134.9%
Shanghai SE (China)	7.4%	-9.7%	-9.7%	-38.1%	219.1%
KOSPI (South Korea)	10.0%	26.0%	26.0%	-7.3%	43.0%
TAIEX (Taiwan)	16.7%	24.4%	24.4%	31.8%	86.7%
FTSE/JSE (South Africa)	16.0%	33.4%	33.4%	26.0%	96.9%
IPC (Mexico)	18.4%	28.8%	28.8%	21.5%	103.1%
USD Total Return					

Source: Bloomberg

MSCI EM	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	6.1%	31.1%	31.1%	35.5%	80.2%
Consumer Staples	4.7%	30.2%	30.2%	44.2%	151.0%
Energy	10.7%	10.1%	10.1%	-20.4%	74.9%
Financials	4.0%	17.2%	17.2%	-0.8%	82.2%
Healthcare	4.9%	27.0%	27.0%	48.5%	76.2%
Industrials	7.3%	28.8%	28.8%	-20.7%	86.6%
Info. Technology	13.7%	16.8%	16.8%	21.2%	39.3%
Materials	11.1%	22.7%	22.7%	4.9%	142.5%
Telecom. Services	2.6%	15.0%	15.0%	-17.0%	81.0%
Utilities	0.9%	9.4%	9.4%	-1.6%	98.6%
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			12/31/09	12/31/10	12/31/09	12/31/10
World Government Bonds	5.2%	3.4%	-0.2	0.22	AA+	AA+	3.2	2.9
United States	5.8%	5.8%	-0.6	0.13	AAA	AAA	3.3	2.9
Canada	12.0%	6.2%	-0.3	-0.07	AAA	AAA	3.9	3.7
Australia	19.8%	5.1%	0.2	-0.10	AAA	AAA	5.9	5.7
Japan	17.5%	2.4%	0.0	0.51	AA	AA	1.5	1.4
Malaysia	16.4%	4.8%	0.0	0.04	A+	A+	4.0	4.0
Singapore	12.2%	2.4%	0.0	0.34	AAA	AAA	3.1	3.0
European Monetary Unit	-5.6%	2.1%	0.2	0.10	AA+	AA+	4.3	4.1
Austria	-0.3%	6.7%	-0.4	0.01	AAA	AAA	4.3	4.2
Belgium	-4.7%	2.0%	0.4	0.18	AA+	AA+	4.5	4.3
Finland	-1.1%	5.8%	-0.3	0.62	AAA	AAA	4.4	3.9
France	-1.6%	5.2%	-0.2	0.32	AAA	AAA	4.2	4.0
Germany	-0.7%	6.2%	-0.5	0.29	AAA	AAA	4.0	3.7
Ireland	-19.6%	-14.0%	3.9	-0.87	AA	A	4.6	4.7
Italy	-7.3%	-0.8%	0.8	-0.28	A+	A+	4.6	4.4
Netherlands	-0.7%	6.2%	-0.4	0.47	AAA	AAA	4.1	3.8
Portugal	-14.5%	-8.6%	2.6	-0.55	A+	A-	4.4	4.4
Spain	-10.4%	-4.2%	1.6	-0.30	AA+	AA	4.5	4.3
Denmark	1.4%	8.6%	-0.7	0.31	AAA	AAA	4.7	4.4
Norway	4.3%	5.0%	-0.3	0.49	AAA	AAA	5.6	5.3
Poland	3.5%	6.8%	-0.3	-0.17	A	A	4.3	4.1
Sweden	9.3%	2.9%	0.2	-0.09	AAA	AAA	4.8	4.7
Switzerland	14.6%	3.3%	-0.2	-0.08	AAA	AAA	3.5	3.4
United Kingdom	4.0%	7.3%	-0.4	0.40	AAA	AAA	4.7	4.5

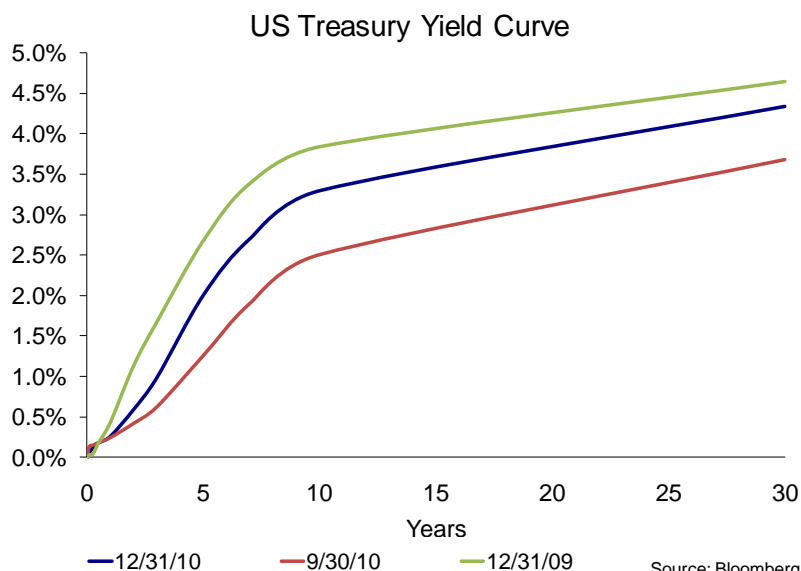
Source: Bloomberg, Citigroup YieldBook

US Fixed Income

During the quarter, US Treasury yields rose across maturities. Yields closed below the year's beginning levels. As we discussed last quarter, we believed that Treasury yields were just way too low and were unlikely to fall much further due to the relative attractiveness of long-term real returns. Many investors began increasing duration risk in their portfolios in order to capture higher yields, and as a result, experienced a sharp mark-to-market loss as rates rose rapidly over the past few months.

While Treasury rates have risen over the past few months, we do not believe that they will continue to rise at the same pace. Instead, we expect the pace to moderate and range trade with an upward trend for 2011. This view is partially due to the reduction in aggregate net issuance scheduled for the year. Despite the passage of

the recent tax package, a strong rebound in tax receipts and steps by the Treasury department to reduce its borrowing capacity are likely to keep government need relatively muted. In addition, there has been a commitment to extend the average maturity of US debt outstanding starting in May 2010. As a result, auctions for 2-7 year debt have been reduced. Moreover, supply has also been reduced and is likely to be reduced further by the Fed being a structural buyer due to its new quantitative easing program.¹⁴ The net effect is likely to result in only a modest rise in yields across maturities for the year.



Source: Bloomberg

Net Agency debt issuance is also likely to be reduced. The focus of Fannie Mae and Freddie Mac has been to buy out delinquent loans while managing their borrowing needs. The size of Freddie's portfolio is currently just below its 2011 limit, making additional purchases more difficult. The size of Fannie's portfolio is currently just below its 2010 limit but well above its 2011 limit.¹⁴ As a result, the two agencies are likely to have net issuances well below 2010 levels.

The reduction in high quality Treasury and Agency debt is likely to be offset by increased issuance of Investment Grade Corporate and High Yield securities. Firms have been taking advantage of low interest rates to refinance their existing obligations and extend out the average term of their debt. There have been a number of instances where debt has either been called or tendered due to robust capital market conditions. On the other hand, investors have been attracted to corporates due to historically low default rates, low mergers and acquisitions activity, improving credit fundamentals, low core inflation levels, and a gradual economic recovery.¹⁵ While we believe default rates may begin to rise in 2012/13 and mergers and acquisitions activity to pickup, fund flows toward high coupon paying securities are likely to remain strong as investors continue to chase yield.

Foreign Developed Fixed Income

The sovereign stresses that Europe has been experiencing are very linked to the credit sector given the high reliance on banks in the region. As a result, there is a direct connection between fiscal tightening and weaker growth. Overall, both sovereigns and corporates are likely to struggle due to funding stress.¹⁰ In addition, troubled nation solvency is likely to weigh on the rest of Europe given the level of cross ownership of public-sector liabilities. Specifically, 75% of Greek, Irish, and Portuguese sovereign debt is held by foreigners, most of which are other European Monetary Unit residents.¹⁶ As a result, we believe that sovereigns and corporates with healthier and cleaner balance sheets are likely to outperform. We have witnessed this throughout 2010 as 10-year spreads of troubled nations, relative to fundamentally stronger Germany, increased substantially.

Emerging Market Fixed Income

Although we prefer equity exposure over fixed income exposure within emerging markets, the emerging market debt story remains intact even though downside risks are gradually rising. Generally speaking, sovereign emerging market credit quality is at historic highs. Regulatory risk has come down quite a bit over the years and has largely become predictable. Economies are growing, but inflationary pressures are on the rise. The Financial sector is in much healthier shape than that of larger developed world counterparts. And, many corporations have deleveraged their balance sheets, termed out debt profiles, and conserved free cash flow over the past decade, particularly in Asia.¹⁰ Although volatility may increase, healthy returns from this asset class are expected to continue.

Commodities Review and Outlook

Commodities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
*Energy	11.6%	1.9%	1.9%	-46.0%	-43.9%
**NYMEX Crude Oil	14.3%	15.1%	15.1%	-4.8%	49.7%
**NYMEX Natural Gas	13.8%	-20.9%	-20.9%	-41.1%	-60.8%
*Precious Metals	12.2%	34.5%	34.5%	69.0%	168.3%
**COMEX Gold	8.7%	29.7%	29.7%	69.6%	173.9%
**Silver Composite	42.1%	83.2%	83.2%	109.0%	250.7%
*Industrial Metals	12.5%	16.7%	16.7%	8.5%	64.8%
*Agriculture	25.0%	34.2%	34.2%	-0.9%	44.1%
*Livestock	2.6%	10.5%	10.5%	-31.1%	-41.3%

* S&P GSCI Official Close Indices TR

Source: Bloomberg

** Price Change

Commodity prices have risen over the past year, led by oil, precious metals, agriculture, and industrial metals. A myriad of factors supported performance, including emerging market growth, weaker US dollar versus most currencies, inflation and market fears, and supply side disruptions. Fund flows to exchange traded and managed futures funds resulted in high correlations amongst commodities.

Going forward, we believe that investors are likely to increase their distinction between commodities as a result of actual demand and supply factors for physicals. This is like to result in a breakdown of correlations and increase the benefits of diversification. Additionally, we are seeing the correlations between equities and commodities decrease, further supporting long-term asset allocation diversification arguments in a portfolio.¹⁷

Term structures for commodity futures are also shifting from contango to backwardation as a result of declining inventories. This should boost spot prices and roll returns, making it an opportune time to rebalance the commodity allocation back up to targets weights in a portfolio.¹⁸

We continue to favor commodities with supply constraints and increased demand. For instance, oil and copper are likely to benefit from stronger than expected global growth at a time when several supply constraints have yet to be resolved. Similarly, foods, including corn, wheat, and soybeans, are likely to benefit from increased demand rationing and tight supplies. We remain cautious toward precious metals, including gold. Furthermore, while we expect commodities as a bucket to advance in 2011, we anticipate more volatility from the asset class than in 2010. We also remain concerned about the universal optimism toward commodities and overextended prices.¹⁷

Currencies Review and Outlook

During the year, the Euro and the British Pound depreciated relative to the US dollar. Meanwhile, the Japanese Yen and most other major currencies gained versus the US dollar.

With the exception of the Yen, we believe this trend to continue in 2011. The fiscal situation and labor slack in major developed markets are likely to weigh on their currencies. Meanwhile, the reluctance of minor developed markets and emerging market nations to allow their currencies to appreciate meaningfully may result in increased inflationary pressures, which can become unsustainably dangerous. In addition, large trade imbalances between the two groups are growing and likely to create long-term systemic issues if this behavior goes unchecked.¹¹ With the naïve mindset of “everything will work out in the end,” we believe that the US Dollar, Euro, British Pound, and Japanese Yen are likely to be weaker against a basket of minor developed world and emerging market currencies.

Major World	Standard		Per USD/USD Gain		
	12/31/09	12/31/10	12/31/09	12/31/10	%
United States	77.86	79.03	77.86	79.03	1.5%
Eurozone	1.43	1.34	0.70	0.75	7.1%
Japan	93.02	81.12	93.02	81.12	-12.8%
Britain	1.62	1.56	0.62	0.64	3.6%
Canada	1.05	1.00	1.05	1.00	-5.2%
Australia	0.90	1.02	1.11	0.98	-12.2%
New Zealand	0.72	0.78	1.38	1.28	-7.0%
Switzerland	1.04	0.94	1.04	0.94	-9.7%
Denmark	5.20	5.57	5.20	5.57	7.1%
Norway	5.79	5.82	5.79	5.82	0.5%
Sweden	7.16	6.71	7.16	6.71	-6.3%
Major Asian	12/31/09	12/31/10	12/31/09	12/31/10	%
Singapore	1.40	1.28	1.40	1.28	-8.6%
Japan	93.02	81.12	93.02	81.12	-12.8%
South Korea	1164.00	1126.00	1164.00	1126.00	-3.3%
Taiwan	31.99	29.30	31.99	29.30	-8.4%
Hong Kong	7.75	7.77	7.75	7.77	0.2%
Thailand	33.37	30.06	33.37	30.06	-9.9%
Malaysia	3.43	3.06	3.43	3.06	-10.6%
Indonesia	9404.00	8996.00	9404.00	8996.00	-4.3%
India	46.53	44.71	46.53	44.71	-3.9%
Philippines	46.16	43.80	46.16	43.80	-5.1%
China	6.83	6.61	6.83	6.61	-3.2%
Central America	12/31/09	12/31/10	12/31/09	12/31/10	%
Belize	1.95	1.95	1.95	1.95	0.0%
Guatemala	8.33	8.02	8.33	8.02	-3.8%
Honduras	18.90	18.90	18.90	18.90	0.0%
Mexico	13.09	12.34	13.09	12.34	-5.7%
Nicaragua	20.84	21.88	20.84	21.88	5.0%
Panama	1.00	1.00	1.00	1.00	0.0%
Costa Rica	565.24	512.97	565.24	512.97	-9.2%
El Salvador	8.75	8.75	8.75	8.75	0.0%
South America	12/31/09	12/31/10	12/31/09	12/31/10	%
Argentina	3.80	3.98	3.80	3.98	4.7%
Bolivia	7.07	6.99	7.07	6.99	-1.1%
Brazil	1.74	1.66	1.74	1.66	-4.8%
Chile	507.45	468.00	507.45	468.00	-7.8%
Ecuador	25000.00	25000.00	25000.00	25000.00	0.0%
Guyana	203.90	204.20	203.90	204.20	0.1%
Paraguay	4672.50	4645.00	4672.50	4645.00	-0.6%
Peru	2.89	2.81	2.89	2.81	-2.8%
Venezuela	2.15	4.29	2.15	4.29	100.0%
Uruguay	19.50	19.90	19.50	19.90	2.1%

Source: Bloomberg

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