Global Equity Opportunities Admidst Geopolitical Unrest

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

JULY 14, 2006

Given the long laundry list of global hotspots (such as North Korea, Iran, Iraq, Lebanon, Gaza, Israel, India, and Nigeria), the world is clearly a dangerous place. As a result, it is not surprising that the financial markets have become unsettled. The most troubling area is the Middle East, due to the risk of spreading conflict in the region and the potential for a "super spike" in oil prices that could slow the global economy. A "super spike" in oil was one of the key risks outlined in our return to recession scenario.

However, although the world has always been a dangerous place, the economy and the financial markets have nevertheless managed to lurch from crisis to crisis in a steady upward progression. We believe this is likely to happen this time, too. In times of crisis, emotion often takes over. Fear dominates our thinking and can overwhelm decision making. Perspective is lost as doom and gloom triumphs. This is when disciplined, well seasoned investment managers earn their keep.

Discipline 1: Stay disciplined.

Disciplined money mangers stick to the long-term strategic plan designed to achieve client goals. They stay true to their principles and methodologies and avoid making costly short-term timing moves, knowing that in the long run their strategy should win. Our solid long-term client strategies seek to provide consistent and competitive returns. We believe our diversified portfolios should hold up relatively well in adverse environments and should be competitive in favorable environments.

Discipline 2: Be patient and avoid making emotional decisions.

During periods of rising angst, volatility can create opportunity. The investment markets must always deal with risk and uncertainty. The question is how much risk is priced into the market? Stocks can stay undervalued for a long time, but eventually value is recognized and patient investors are rewarded. Have faith in the long-term strategy. Don't get whipsawed by constantly changing strategies.

Discipline 3: Make portfolio tilts around long-term strategies only when absolute and relative valuations are compelling.

With the S&P 500 P/E trading at 13.5 times forward earnings, inflation and interest rates relatively low and earnings estimates still moving higher, U.S. stocks are cheap. With the median country P/E trading at about 12 times forward earnings, global stocks are cheap as well. Relative to other assets, both U.S. and international stocks look very attractive. This is in stark contrast to the high absolute and relative valuations at the bull market peak in 2000. In the table below, we show the current yield level for various asset classes in March of 2000 and today.

Discipline 4: Consider multiple economic and market outcomes to evaluate risk.

As mentioned above, one of the risks is a further deterioration of the situation in the Middle East and an oil price spike driven by speculators, panic buying and a disruption in the oil supply. Another

CURRENT YIELD LEVELS

ASSET YIELD	MARCH 2000	JULY 2006
S&P 500 EARNINGS YIELD[1]	3.60%	7.50%
INTERNATIONAL STOCK EARNINGS YIELD[2]	4.00%	8.30%
REAL ESTATE CAP RATE[3]	9.00%	5.70%
TEN-YEAR TREASURY BOND YIELD	6.50%	5.06%
90-DAY T-BILL RATE	6.50%	5.04%

1 12-month forward Thomson S&P 500 earnings estimate divided by price
2 12-month forward Thomson median country earnings-to-price
3 National Council of Real Estate Investment Fiduciaries (NCREIF)

Sources: Bailard Research, Thomson Financial, NCREIF key risk is a Fed policy mistake in which the central bank overreacts to inflation and tightens too much. Both of these events could trigger a recession. Fortunately, we place only a 20% probability on this outcome.

Our base case continues to look for a moderation in economic growth, contained inflation and the Fed being close to the end of its tightening phase, if not done already. If we are wrong, we believe it is likely that the global economy will remain more robust than anticipated and the positive earning cycle will continue.

Discipline 5: Pay attention to what the markets are telling you.

Although we have seen global stock prices correct from recent highs, they are still higher than a year ago. Many markets are still up 2006 year-to-date. As long as the long-term trend is up, we believe the benefit of the doubt should be given to the compelling valuation in stocks and a strong expected fundamental environment.

Summary: Market reactions to rising geopolitical tensions tend to be short lived and create buying opportunities.

The fundamental background for both U.S. and international stocks remains compelling. Valuations are cheap and the earnings cycle continues to move higher. Although we may have to wait until global tensions ease for this value to be unlocked, our patience should be rewarded. Turning points are very difficult to predict or time. It could be tomorrow or six months from now. Given that the stock markets are oversold and sentiment is extremely negative, the opportunity for a strong rally in stocks is being created. Finally, as always, we should take a great deal of comfort in knowing that we are well diversified and have solid long-term strategies in place.

Sources: Bailard Research, Thomson Financial, National Council of Real Estate Investment Fiduciaries, Oak Associates, Bloomberg

DISCLAIMER

For more information, please call 800.BAILARD (800.224.5273) or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404

Bailard

INVESTING. **REDEFINED.** ®