

## BAILARD INTERVIEW

### Spotlight on Commercial Real Estate

**Senior Vice President Real Estate Michelle Foss discusses the recent downturn in commercial real estate.**

*Fourth quarter 2008 was commercial real estate's worst quarter on record. What happened?*

From 2004 through 2007, commercial real estate enjoyed robust double-digit returns. While returns were tepid through the first three quarters of 2008, the situation changed dramatically in the fourth quarter. During that three month period, the National Council of Real Estate Investment Fiduciaries National Property Index (NCREIF NPI) returned -8.3%, easily outstripping the index's previous record decline of -5.3% in the fourth quarter of 1991.

This downturn can be attributed to several factors. Last fall's financial panic resulted in a repricing of risk across all asset classes, including commercial real estate. Required returns increased at the same time the outlook for rent growth declined significantly. In recognition of the rapidly changing environment, 87% of the properties in the NCREIF NPI were revalued during the fourth quarter, compared to a historical average of closer to 30%.

Not surprisingly in an era of constrained liquidity, large properties received the steepest write-downs in the NPI. Properties worth \$1 billion+ experienced an average 14.4% value decline,

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while properties under \$100 million received an average 9.1% write-down. Again not surprisingly, large downtown office properties over \$300 million were the worst performing property type with a 15.4% decline in value; Manhattan office fared even worse with a 17.7% write-down.

## *Why isn't there any liquidity in commercial real estate right now?*

Commercial real estate is a leveraged asset class. Most transactions are financed with mortgage loans, and there is almost no commercial mortgage debt available right now. Many lenders are focused on shoring up their own balance sheets, while the commercial mortgage backed securities market is completely shut down. The little debt that is available usually comes at the cost of higher spreads, tighter underwriting standards, lower loan proceeds and more strenuous covenants. Financing has become very difficult to obtain, severely constricting new property acquisitions. Sales transaction volume in February was down -80% year-over-year. Only 40 properties (0.6%) of the nearly 6,300 properties in the NCREIF NPI were sold during the fourth quarter – the lowest number ever.

The supply of properties on the market for sale greatly exceeds demand, as sellers come under increasing pressure and jittery buyers are content to wait on the sidelines for better pricing or more clarity about the future of the economy. The current perception in the market is that only distressed sellers (particularly overleveraged owners) would be marketing a property for sale in this environment. The lack of both equity and debt capital means that the asset class is virtually illiquid – but we believe this circumstance creates a tremendous buying opportunity for those with capital to deploy going forward.

## *How prevalent is distress among property owners? It certainly seems to be making headlines.*

Until recent months, property fundamentals remained quite healthy, enabling borrowers to continue to make debt service payments. However, delinquency rates, while still near historic

lows, spiked during the fourth quarter of 2008, nearly doubling to 1.2%. As a point of comparison, delinquencies ran approximately 2% earlier this decade and in the high single-digits in the early 1990s. So while distress is currently confined to those few overleveraged office, retail and casino operators in the headlines, the sharp uptick in delinquencies illustrates that pressure is increasing. In addition, the ongoing lack of available debt capital, coupled with significant upcoming debt maturities in commercial real estate beginning in 2010, will likely further stress the asset class. Without a thawing in the credit markets, owners will likely face increasing pressure to sell.

## *How are fundamentals holding up?*

Commercial real estate fundamentals are being impacted by the recession. NPI vacancy rates at the end of 2008 were up 180 basis points (1.80%) across all property types since the low point achieved in the third quarter of 2007, and net operating income growth has turned slightly negative. We expect continued strong downward pressure on occupancies and rents as job losses mount. Different property types can expect varying degrees of deterioration in fundamentals, with apartments generally expected to hold up best. While job losses most directly impact the demand for office space, they also affect consumer spending, imports and household formation, the key drivers of retail, industrial and apartment property types, respectively. Fortunately, fundamentals entered this downturn in a position of strength, with neither the supply overhang (from new property construction) nor the phantom demand (from start-up companies reserving space for growth) that were the hallmarks of past downturns.

## *What does all this mean for the asset class going forward?*

We believe the current lack of liquidity in commercial real estate, combined with the repricing of the asset class and the potential for distressed sellers, set up a historic cyclical buying opportunity akin to that of the early 1990s. We

## Spotlight on commercial real estate (continued)

are starting to see attractive acquisition opportunities and expect these conditions to persist for some time. While it is not the time to be a seller of commercial real estate, it is certainly the time to be thinking about buying. Consensus estimates currently indicate another year of negative returns for the asset class, but, according to our analysis, as price declines ease, commercial real estate should revert to its historical role as a stable, primarily income-producing asset with long-term inflation growth potential.

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# The seeds for an U.S. economic recovery are being planted

**Final fourth quarter GDP was revised down to -6.3%, the U.S.'s worst quarterly economic decline since the deep recession of 1982.** In the first quarter of 2009, the GDP number is likely to be a bit better but will still probably decrease about -4%. There are faint signs of what may be the beginning of a recovery later in the year, and the feeling of free falling and panic of last October has eased.

It is hard to envision the economy making much progress as layoffs continue and hiring remains soft. New unemployment claims, the timeliest measure of layoffs, remain near their highs. The U.S. economy is also continuing to lose over 600,000 jobs per month. As a result, the national unemployment rate could spike to 10% by summer.

That said, labor market indicators are historically the last to turn in an economic recovery. Despite the deterioration in labor markets, consumer spending has held up better than expected. With inflation slowing, real incomes and purchasing power are improving at a modest pace, rising an annualized 4.2% over the three months ending in February. Real consumer spending has stabilized and the savings rate has moved to 4.5%.

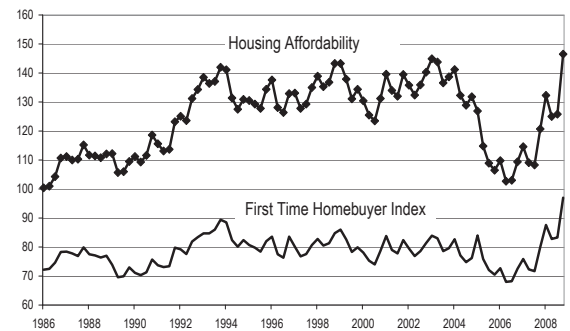
## Improving Outlook for Housing

The most encouraging sign is an improving outlook for housing. Given the sharp decline in home prices and lower mortgage rates, housing affordability has increased to record levels (see Chart 1). Housing affordability indicates the percent of a median priced house that a homebuyer with a median income can afford at current interest rates. For example, at 160, a homebuyer with a median income can afford 160% of a median priced home.

Job insecurity is holding back some potential homebuyers. Nevertheless, in February, new home sales, existing home sales and the National Association of Realtors Pending Home Sales Index were all surprisingly strong. Mortgage applications at the end of March were 20% ahead of last year. Refinancing activity has been particularly robust. After three years of a hous-

ing recession, there is a sizable pool of pent-up demand. Record affordability and the increased availability of mortgage financing at some point should trigger a strong housing recovery. However, the initial stages of the housing recovery will likely see the drawdown of excessive inventories of unsold homes rather than the construction of new homes.

CHART 1



Source: Bloomberg, L.P.

## Seeds of Economic Recovery

While many things can still go wrong, the seeds of economic recovery are being planted. The Fed has aggressively eased and continues to provide liquidity to the banking system. Short-term interest rates have come down, mortgage rates are declining, and oil prices and inflation have fallen, restoring consumer purchasing power. Treasury Secretary Geithner's "Financial Stability Plan" is also helping to shore up the financial system. The Housing Stability Initiative is helping distressed homeowners avert foreclosures. The Capital Asset Pricing Program is stress testing banks and will provide capital infusions where needed. The Public Private Investment Program is being put in place to "ring fence" the toxic or legacy assets that were based on bad mortgages. This program should help restore bank capital and reduce asset write-downs. The Term Asset Backed Lending Facility, which is now in operation, is designed to increase liquidity in the consumer, small business and student loan credit markets.

Most importantly, the Financial Accounting Standards Board has revised the mark-to-market (M2M) security valuation rule that was one of

# The seeds for an U.S. economic recovery are being planted (continued)

the main causes of the vicious downward cycle in the financial sector last year. Under the original M2M rule, banks valued their asset-backed security portfolios based on distressed market prices. This led them to write down the value of their securities to distressed levels, which in turn lowered the banks' capital ratios and forced them to sell more assets into depressed markets. Now, the revised M2M rule gives auditors greater discretion to use their judgment as to how to value distressed assets.

## What Could Go Wrong?

Given all of these positive developments, what could go wrong? While the private sector is rapidly deleveraging its balance sheet, the federal government is rapidly leveraging its balance sheet. Although the fiscal stimulus program will help the economy on the margin, because of the timing of spending, most of the stimulus won't even take place until 2011.

Nevertheless, federal outlays are skyrocketing. According to the Congressional Budget Office, the federal deficit will climb to \$1.8 trillion in 2009, drop to \$658 billion by 2012 and climb back to \$1.2 trillion by 2019. Total federal debt held by the public will climb from the \$7.2 trillion baseline in 2009 to \$11 trillion in 2012 and \$17.3 trillion in 2019. In addition, the Federal Reserve Board has been expanding its balance sheet to inject liquidity into the financial system. It has doubled its asset base over the last year and is expected to double it again to \$4 trillion over the next twelve to eighteen months. Eventually, the Fed will have to pull liquidity out of the system and stop printing money, or we will face an inflationary problem down the road.

To make matters worse, both Social Security and Medicare are expected to swing to a negative cash flow position in the future. When that happens, they will have to sell the government securities held on their books to cover the cost of their benefit payments.

Given the large amount of debt that needs to be financed, when the economy recovers, interest rates are likely to slingshot higher, potentially

reducing growth. Without sustained growth, the tax base will not grow as much and tax revenues could be less than expected. Long-term growth is likely to also be impeded by higher taxes on income, dividends and capital gains at the federal level and a race to raise fees and taxes at the state level.

## Outlook for the Economy

The bottom line is that we believe the U.S. economy will start recovering later this year. While we are not currently concerned about inflation, we do see the potential for pricing pressures down the road. We are also keeping a close watch on the federal government's growing funding problem.

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## Hard hit by recession, most developed countries are likely to lag the U.S. in entering a recovery

**While the U.S. economy is showing some indications of bottoming (or at least a slowdown in the rate of decline), the rest of the developed world is still contracting.** Global trade dropped -9% in 2008 due to declining demand. Exports everywhere are off dramatically, with some Asian countries (such as Taiwan and Korea) seeing year-over-year export declines on the order of -50%.

### Europe

The European recession has already been worse than that of the U.S. Year-over-year, U.K.'s GDP is off -1.9% and Eurozone's GDP is down -1.3%, compared to America's -0.8%. Europe is facing many of the same problems as the U.S.: a housing boom bust, credit market illiquidity, bank loan losses, and ongoing consumer and business deleveraging. Exports, capital spending and consumption all look pretty grim.

In the past, the larger size of the government sector and labor market inflexibility tended to mute Europe's economic downturns. However, this time around, Europe faces other problems. Its ability to take on more debt is limited by the already high level of government debt and negative demographic trends such as an aging population.

Western Europe also has a Central and Eastern European debt problem. These export-dependent countries borrowed heavily in euros and in Swiss francs during the last economic expansion. With the global economy slowing, exports are taking a hit, national currencies are falling, and the Central and Eastern European countries' ability to repay their debt is declining. Western European banks may be left holding the bag. Given the condition of the global banking system, this is the last thing the Western European banks need.

Any European recovery remains heavily dependent upon aggressive monetary ease and fiscal stimulus. The problem with monetary policy is that, even in normal times, its impact is typically felt with a variable lag of twelve to eighteen months. Today, with all the problems in the

financial system, the lag time could be even longer. In addition, Europe was slow to adopt fiscal and monetary stimulus measures. As a result, Europe's recovery may not occur until well after the U.S. economy rebounds.

### China

Chinese growth has slowed along with that of the rest of the world. Exports began to slip in the fourth quarter of last year, as global demand dropped precipitously. Both Chinese exports and imports fell by the largest amount in 27 years. Fourth quarter GDP slowed to a 6.8% year-over-year growth rate, down from 9% year-over-year in the third quarter. In our opinion, many observers overestimate the importance of net exports to the Chinese economy because the absolute numbers are so large. However, over the last five years, net exports accounted for only about 2% of China's average annualized growth of 11%. Since China is the low cost producer in Asia, its exports tend to hold up better than those of other Asian countries during global economic downturns. We are more concerned about the collapse of property prices in the coastal regions, the rising unemployment rate and the falling confidence that is slowing growth in the cities.

Nevertheless, China is still in relatively good shape. With almost \$2 trillion in foreign currency reserves, it has the financial strength to underwrite its own recovery. In November of 2008, the government passed a \$586 billion economic stimulus package. Given that China's economy is only one quarter that of the U.S., the relative size of the stimulus is much greater. In addition, unlike the U.S. stimulus package, China's package is heavily weighted toward infrastructure spending which should provide an immediate boost to the economy. Moreover, China's unleveraged consumer sector saves 45% of its income. If the government can ever unlock some of this potential consumer demand by beefing up the social safety net and mutualizing health and property insurance, China should be set for years. Finally, China has adopted an aggressively easing monetary policy as well as initiatives (including tax cuts) to prop up its property market.

China is still in relatively good shape.

## Hard hit by recession, most developed countries are likely to lag the U.S. in entering a recovery (continued)

All of these positive actions have not gone unnoticed. Chinese A-Share stocks as measured by the CSI 300 index are up 38% for the first quarter.

### Japan

Japan's economy shows little sign of life. Industrial production plunged -9.4% in February, following a record -10.2% drop in January and a -9.8% decline in December. Those are month-to-month, not year-over-year, changes! Industrial production is down an unprecedented -34.9% (not annualized) over the past five months. A lot of the decline in production can be attributed to the global slowdown in exports. Japanese exports fell -49% year-over-year in February.

Weakness in the domestic economy has also contributed to the weakness in production. Retail sales fell a much worse than expected -5.8% year-over-year in February, down -25% from December. There are few signs that things are about to get any better. The Diffusion Index of Leading Economic Indicators and the Leading Indicator itself remain very weak, suggesting at least six more months of stagnation. With monetary growth unable to gain any traction, it is too early to see a turn. However, the Japanese government is moving toward a more aggressive stimulus package, and, if the U.S. begins to recover, Japan, like the rest of the world, will probably follow.

If the U.S. begins to recover, the rest of the world will probably follow.

# Risky debt performed better than U.S. Treasury debt in the first quarter

**The first quarter was another wild one for the U.S. bond markets. Overall results were downright dull, with the Merrill Lynch U.S. Corporate, Government and Mortgage bond index up 0.1%.**

This basically flat return masked a reversal of the “flight to safety” trend that occurred in the latter part of last year. During the first quarter of 2009, the safest debt had the worst performance. Long-term U.S. Treasury bond yields rose as much as 85 basis points (0.85%), leading to a -1.4% return for the Merrill Lynch U.S. Treasury 10+ year index. Alternatively, “all things risky”, which had taken it on the chin for much of last year, had their time in the sun. High yield debt, as measured by the Merrill Lynch High Yield Cash Pay index, rebounded with a 5.3% return for the quarter. In addition, the Merrill Lynch Municipal Master index of municipal bonds advanced 4.4% for the period despite increasing state and local budget deficits.

It was a trying quarter for policymakers who wanted to inject liquidity into the financial system while at the same time bring down borrowing costs across the board. Net issuance was marginally positive for the quarter. But beyond this, almost as fast as the U.S. Treasury issued debt to finance government programs, the Fed purchased it in an attempt to contain yields. By the end of the quarter, the Fed had instituted programs to purchase mortgage-related and student loan debt as well as Treasury debt in an effort to bring down borrowing costs. So far, the results have been less than inspiring. Although the Fed has plenty of powder left to purchase more securities, the first tranches have barely nudged the market.

## Reduced Fears of Deflation

By one measure though, the market is not as pessimistic as it was last quarter. Looking at the difference between the yields on traditional U.S. Treasury debt and the yields on Treasury Inflation Protected Securities (TIPS), one can derive the market implied forward inflation. At year’s end, investors were pricing in deflation (-0.5% price change annually) going out five years. That measure is now a positive 0.5%. Over a ten-year

horizon, the market has moved from an expectation of essentially flat prices to one of 1.3% annual inflation. If nothing else, the massive liquidity injected during the first quarter has quieted fears of deflation.

## Corporate Credit Spreads

Corporate credit spreads remained frustratingly high. The spread above Treasuries that the typical investment grade corporate borrower was forced to offer lenders declined slightly from 6.0% to 5.9%. For speculative grade borrowers, the similar numbers were 18.1% and 16.8%. Some would argue that a sustainable rally in equities can’t occur until borrowing costs such as these come down.

## Death of AAA-Rated Bonds?

In the “wow, the game has really changed” department, the number of AAA-rated corporate borrowers continues to shrink. Twenty years ago, AAA-rated bonds represented almost 17% of the corporate bond universe. As of the end of this quarter, (which saw General Electric and Berkshire Hathaway lose that coveted rating), AAA debt now represents 0.7% of that universe. The number of U.S. corporations which are still rated AAA can literally be counted on one hand.

## Municipal Debt

On the municipal side, state and local authorities are raising income, use and sales taxes in an attempt to balance budgets. Although these tax increases will blunt the impact of stimulus from the federal government, they will also allow state and local governments to continue to provide many essential services. Investors have been lured back into the municipal bond market by the outsized yields that existed late last year, and issuers have taken advantage of that buying spree by issuing new debt. This buys cities, counties and states some additional time as they wait for revenues to stabilize. We continue to focus on municipal bonds which are supported by the broadest tax bases possible, cognizant that through this period many smaller municipalities may face severe default risk.

The safest debt had the worst performance.

# Risky debt performed better than U.S. Treasury debt in the first quarter (continued)

## FOREIGN EXCHANGE

Global investors continued to treat the U.S. dollar as a safe place to park capital in the first quarter, allowing the greenback to rise against fourteen of the sixteen major currencies. The U.S. dollar fell only against the Norwegian krone and the Brazilian real, while it gained anywhere from 5% to 9% versus the euro, the Swiss franc and the Japanese yen.

### China Flexes its Muscles

The biggest news for the foreign exchange markets came at quarter's end, as world leaders were preparing for the G-20 summit. China issued several statements expressing its concern over the long-term value of its U.S. Treasury holdings and, separately, the possible need for a global reserve currency as an alternate store of value in addition to the U.S. dollar. Together, these pronouncements indicate that China would like to reduce its ownership of U.S. Treasury debt over the long term.

It is in China's best interests to make such statements gently and to act even more so. The pressure from the Chinese selling of Treasury debt could dramatically increase U.S. interest rates and diminish the value of China's remaining Treasury bond holdings. Nevertheless, over the past several years, Chinese policymakers have demonstrated an ability to be very consistent in fulfilling policy objectives which in the past would have been dismissed as simple rhetoric. In mid-2005, for example, many were skeptical when China announced its intention to allow the Chinese yuan to rise relative to the U.S. dollar, given the adverse impact the currency movement would have on its exporters. But the naysayers have been proven wrong as the yuan has gradually risen to more than 20% versus the dollar since the date of that pronouncement.

China also proposed the creation of a new reserve currency akin to Special Drawing Rights. That basket consists of 44% U.S. dollars, 34% euros, 11% Japanese yen and 11% British pounds. Under China's proposal, the new reserve currency might have a higher Asian exposure and possibly include some gold as well.

Regardless of what happens to these specific proposals, the G-20 summit was China's "coming out" party. The country is clearly going to change the face of global capital flows over the next several years. To the extent it is successful in achieving its policy objectives, the dollar will likely be in for a more difficult time.

### Short-Term Outlook for the Dollar

In the short term, though, as the world struggles out of the recession, the dollar is likely to remain relatively strong. Japan's prospects in navigating this crisis are tepid at best and exacerbated by the relative strength of the yen relative to its trading partners over this period. With continued weak domestic growth and export growth strangled by its too strong currency, we are likely to see renewed yen weakness in the future. Elsewhere, the most likely major currency to be a candidate for near-term weakness is the Swiss franc. This is necessitated by the volume of loans made to Eastern Europe. A strong franc makes defaults on this debt much more likely. Such defaults would put an extreme strain on an already stressed Swiss banking system, given that bank loans to Eastern Europe are greater than Switzerland's GDP.

China is clearly going to change the face of global capital flows over the next several years.

# Despite a March rally, U.S. stocks had another negative quarter

Beaten down, low quality and lower priced stocks performed particularly well during the March rally.

**The U.S. stock market continued its slide at the start of 2009, adding to the pain that investors felt through 2008. All of the major U.S. equity indices with the exception of the NASDAQ 100 posted negative returns for the first quarter.** The S&P 500, a gauge of the 500 largest stocks within the U.S. market, lost -11.0% for the period. Small cap stocks (in particular small cap value stocks) underperformed their larger cap counterparts, with the S&P SmallCap 600/Citigroup Value index losing a hefty -18.8%. The Dow Jones Industrial Average, a well known and well recognized index of 30 companies, was also lower, posting a -12.4% return for first quarter. The only bright spot was the NASDAQ 100, a technology heavy index in which financial companies are conspicuously absent. This index actually rose 2.3% for the quarter.

## Stocks Rallied in March

Although the first quarter ended on a negative note, the U.S. stock market did rally sharply after hitting a new low on March 9th. In the three weeks from March 9th to March 31st, the S&P 500 rose 18.1%, the S&P SmallCap 600/Citigroup Value index advanced 23.5% and the NASDAQ 100 gained 18.5%.

Beaten down, low quality and lower priced stocks performed particularly well during this stock market rally. Research shows that, out of the large cap Russell 1000 index, stocks with a price of less than \$3 at the end of February gained 69.8% from March 9th to March 31st, and stocks with a price of less than \$5 gained 52.6% over the same time period. Higher quality stocks (i.e., companies with a strong track record of returning cash to shareholders, strong repeatable and sustainable earnings streams, and strong balance sheets) underperformed significantly. Higher quality companies tend to be neither universally cheap nor expensive, but our analysis suggests they have, on average, performed well over the long run.

## Is the Rally Sustainable?

Most investors want to know if the March rally was fleeting or if it was the start of something more sustainable. We believe a sustainable

stock market rally will occur only when investors gain greater confidence that we are closer to the trough in earnings, when we see some signs of stabilization in house prices and/or inventory levels, and when the growth outlook becomes more transparent as cyclical risks diminish.

If investors gain more confidence that the systemic risks plaguing the financial system have been reduced and that widespread nationalization is a less probable outcome, the focus should return to earnings growth, earnings sustainability, valuation metrics, and balance sheet strength. When this happens, we expect to see a sustainable return to the quality theme of investing.

# International stocks also posted negative returns for the quarter

The first quarter of 2009 marked the sixth consecutive negative quarter for the broad international stock markets. From its peak in the fourth quarter of 2007, the MSCI All Country World ex-U.S. (U.S.\$) international stock index has declined a cumulative -54.2% through March 31, 2009. During the first quarter, the index fell -10.7%, a result which would have been much worse if not for a strong rebound in March. The strong dollar continued to adversely affect returns for U.S. dollar investors.

Two interesting developments occurred in the first quarter. First, when the international equity markets rallied in March, as in the U.S., lower quality companies tended to perform better than higher quality companies. This was a reversal of a previous pattern in which higher quality companies had tended to perform the best. Second, Europe, Japan and other developed countries significantly underperformed their emerging market counterparts. The developed markets as measured by the MSCI EAFE index declined -13.9% in U.S. dollar terms. In contrast, the MSCI Emerging Markets index (U.S.\$) actually managed to post a positive 1.0% return for the quarter.

## Developed Markets Versus Emerging Markets

The disparity in returns between the developed and emerging markets reflects in part the differing economic experiences and outlooks for these countries. As discussed earlier in this newsletter, the developed markets of Europe and Japan have been particularly hard hit by the global recession. Their recovery is likely to lag the U.S.'s upturn. The emerging markets, on the other hand, entered the downturn in better macroeconomic shape and with less exposure to the toxic assets that have derailed so many developed countries' economies.

The less developed nations also appear better poised to ride out this global recession. Although weak exports have slowed growth, emerging markets still have relatively healthy domestic demand and a chance to achieve positive growth this year. Their low cost of production will probably lead to an increase in market share

when the global economy begins to recover. The current crisis is also teaching these countries the importance of promoting and developing domestic investment, thereby reducing their dependence on exports to drive economic growth.

## Looking Forward

Both developed and emerging market stocks continue to be attractively valued. When the current financial crisis is resolved and investors no longer flock to the safety of the U.S. dollar, American investors in international stocks are also likely to once again benefit from currency trends.

Developed markets significantly underperformed their emerging market counterparts.

# Commercial real estate returns turned negative in the fourth quarter

Real estate investors can remain thankful that they have had some diversification from the even more volatile and disastrous public securities markets.

**Real estate returns, as measured by the NCREIF NPI, have a justified reputation for lagging behind the real transaction markets.** Appraisers are most comfortable in setting prices where they have a number of valid market comps, and, of course, this data is backward-looking as the transactions occur prior to the appraisals. In addition, many properties in the NPI are only appraised once a year, resulting in a further smoothing in the reported returns.

There will probably be another one to three quarters of declines before we will see the real estate markets begin to stabilize. But, even in these difficult conditions, real estate investors can remain thankful that they have had some diversification from the even more volatile and disastrous public securities markets. For example, in the ten years ending December 2008, the NCREIF NPI had a +10.5% annual return versus the -1.4% annual return realized by the S&P 500 U.S. stock index.

The situation was different in the fourth quarter NCREIF NPI report. Instead of the usual 61% to 68% of the properties being revalued, a record 87% of the 6,287 properties in the index were reappraised! Even though only 40 properties were sold out of the index in the quarter (an all-time record low), appraisers and advisors worked hard to reflect what most observers believe is happening to real prices in the commercial property arena. The 40 sold properties recorded a -14.8% price drop, reflecting the fact that this was a terrible environment in which to have to sell properties. Everyone else decided to wait for better market conditions, but still wrote down values an average of -10.9 % on all independently appraised properties.

### NCREIF NPI Returns

The total returns (income plus price change) reported for the fourth quarter and for all of 2008 were the lowest since the beginning of the NCREIF NPI Index in 1978. Moreover, as Table 1 indicates, no property types were immune from the downturn.

Table 1:  
NCREIF NPI Total Returns

	Q4 2008	Year 2008
Apartments	-8.39%	-7.29%
Industrial	-7.96%	-5.76%
Office	-9.26%	-7.29%
Retail	-6.30%	-4.11%
All Properties	-8.29%	-6.46%

Source: NCREIF

# We will be looking for opportunities to add back to U.S. and international stocks

During the quarter, we reduced our allocation in both U.S. and international equities to an underweight position. After trading in a volatile range from late November to the middle of February, the stock market broke to a new low in early March. Concerned about the possibility of another cascading leg down in the market like we saw last fall, we decided to raise some cash as a risk control measure. This was a difficult decision to make since we continued to see stocks as very attractively valued, believed the market to be very oversold and preferred to be on the other side of the prevailing crowd psychology. However, we considered the break to a new low in the midst of a financial deterioration in Eastern Europe, growing concerns about commercial real estate debt and the sharp move toward bigger government as potential catalysts for more weakness. Fortunately, as we write, stock markets around the world have rallied and hopefully a new bottoming process has begun.

## Global Bonds: Underweight

Ten-year U.S. Treasury bond yields rose 50 basis points (0.5%) during the quarter, after plunging to 2.0% in December of last year. Nevertheless, government bond yields are still only about half of where they were at the start of the financial troubles in July 2007. Given today's deflationary, fear-driven environment, Treasury yields at this level are not absurd. However, coming out the other side of the recession, we believe yields are likely to spike much higher as the "fear trade" is reversed. In addition, given the Congressional Budget Office's outsized projections of deficits and debt as far as the eye can see, financing concerns and inflation expectations are likely to ramp up quickly and drive yields higher.

Outside of the government bond arena, debt yields are more attractive. While yield spreads (the difference between the yield on a risky bond and the yield on comparable maturity U.S. Treasury bond) have narrowed significantly in some areas (like agency and mortgage backed debt), the spreads are still wide in both the investment grade and high yield corporate bond markets.

## U.S. Stocks: Underweight

U.S. stocks are extremely undervalued according to our normalized earnings based model, particularly given the low level of interest rates and inflation. We normalize earnings to smooth out the earnings variability over the economic cycle. Earnings tend to fall sharply during economic downturns and to rise sharply during economic upturns. This earnings variability can cause distortions in the price/earnings multiple used to value stocks. Smoothing earnings provides a better view of the underlying or sustainable earnings from which to value stocks. As of this writing, the U.S. stock market as measured by the S&P 500 index is valued at 10.7 times five-year normalized earnings. This is considerably below the long-term average normalized P/E going back to 1870 of 16.1.

As mentioned above, a new bottoming process appears to have started in March. What we would like to see before we venture more heavily into equities is for the market to successfully test the lows, reestablish a new uptrend and prove itself. Given the shock of the recent bear market, we would expect any upturn to be volatile and to provide plenty of opportunities to reposition ourselves.

From a fundamental standpoint, while the U.S. government appears to be making great progress on the banking situation, we may be trading in one set of problems for another. Higher taxes, burgeoning government debt and the burdens of new regulation may act to dampen the next recovery. However, America has shown its resiliency in the past, and perhaps the traditional monetary measures that lead to economic recovery are beginning to take hold.

## International Stocks: Underweight

International stocks, like U.S. stocks, enjoyed a strong rally in the last three weeks of the quarter, with individual markets up 15% to 30% off their March lows (MSCI country indices, U.S. \$). However, most international stock markets remain in downtrends and have yet to put in solid bottoms. The developed markets, for example, are behaving very much like the U.S. stock

A new bottoming process appears to have started in March.

## We will be looking for opportunities to add back to U.S. and international stocks (continued)

market. Nevertheless, a number of other international markets appear to have either started new uptrends or to be carving out solid bottoms. Emerging markets in general never followed the U.S. market to new lows in early March and seem to be putting in a solid bottom. International stocks also continue to look as attractively valued as the U.S. When we increase our U.S. stock allocation, we will likely move more heavily into international stocks as well.

### Real Estate: Neutral\*

Commercial real estate returns continued to give way under the weight of a very difficult economic and financial environment. Fundamentals have deteriorated due to a more difficult operating environment, and capitalization rates have risen as well. Both factors are adversely affecting returns. Over the next year, we are expecting the lower valuations to attract new buyers and create opportunities in the market.

### Alternative Assets: Neutral\*

We are constantly looking for ways to enhance returns and/or lower risks. Some alternative investments offer diversifying opportunities to offset the risk inherent in equity only portfolios, while others seek to enhance returns by applying specialized expertise and rigorous methodologies to target long-term investment opportunities.

\*Real estate and alternative investments are not suitable for all investors.

When we increase our U.S. stock allocation, we will likely move more heavily into international stocks as well.

U.S. INTEREST RATES	6/30/2008	9/30/2008	12/31/2008	3/31/2009
<b>Cash Equivalents</b>				
90-Day Treasury Bills	1.74%	0.92%	0.09%	0.21%
Federal Funds Target	2.00%	2.00%	0.25%	0.25%
Bank Prime Rate	5.00%	5.00%	3.25%	3.25%
Money Market Funds	2.23%	2.25%	2.29%	0.72%
<b>Bonds</b>				
30-Year U.S. Treasury	4.53%	4.31%	2.68%	3.54%
20-Year AA Municipal	4.64%	5.14%	5.21%	4.93%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 3/31/09	QUARTER	YEAR TO DATE	ONE YEAR
<b>U.S. Bonds</b>			
Merrill Lynch 7-10 Year Treasury Index	-1.30%	-1.30%	9.62%
Merrill Lynch 7-10 Year Agency Index	-1.00%	-1.00%	7.78%
Merrill Lynch 5-10 Year Corporate Index	-0.57%	-0.57%	-10.24%
Barclay Capital Municipal Bond Index	4.22%	4.22%	2.27%
<b>International Bonds</b>			
Citigroup non-US\$ World Government Bond Index, fully hedged	0.05%	0.05%	5.80%

Sources: Bloomberg, L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 3/31/09	QUARTER	YEAR TO DATE	ONE YEAR
<b>U.S. Stocks</b>			
Dow Jones Industrial Average	-12.44%	-12.44%	-35.90%
S&P 500	-10.98%	-10.98%	-38.06%
NASDAQ 100	2.32%	2.32%	-30.14%
S&P SmallCap 600/Citigroup Value	-18.76%	-18.76%	-38.78%
<b>International Stocks</b>			
MSCI Japan, net dividends	-16.62%	-16.62%	-35.98%
MSCI Europe (includes UK), net dividends	-14.56%	-14.56%	-49.91%
MSCI EAFE (Europe, Australia, Far East), net dividends	-13.94%	-13.94%	-46.51%

Sources: Bloomberg, L.P. and S&P Micropal

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 3/31/09	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-8.29%	-8.29%	-15.57%

Source: The National Council of Real Estate Investment Fiduciaries

\*Return for latest quarter is lagged by one quarter.

Past performance is no indication of future results.

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#### About *the 9:05*

Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as the 9:05.

Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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