

BAILARD INTERVIEW

Emerging Markets, Wave of the Future?

Eric P. Leve, Senior Vice President of International Equity Research, gives his views on the long-term outlook for emerging markets.



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The global investing climate is dramatically different than two years ago. Where do you think the best investment opportunities now are?

Both the U.S. and the international stock markets have experienced significant losses in the last two years due in part to systematic weakness in the global financial markets. However, taking a step back and trying to look beyond this downturn, I believe emerging markets offer some of the best long-term investment opportunities today.

That's surprising to hear given the magnitude of the emerging markets' correction over these past two years.

Don't get me wrong. I am not predicting stellar returns in the short term. I think this downturn has "legs" and may take a while to resolve. Moreover, emerging markets are by their very nature riskier than developed markets and thus likely to experience more volatility than their developed market counterparts.

But the market upheaval of the last two years has not derailed the long-term trend toward dramatic development in the broad emerging market economies. The rise of what we currently call the emerging markets began a decade ago and is

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likely to continue over the next 20 or 30 years. Although the development of these economies will not always be smooth – there will likely be many gut-wrenching episodes along the way – I believe the evolution will produce much greater wealth, especially in Asia. As a result, emerging markets will likely be a critical long-term portion of all global investors' portfolios.

How are investors responding to the development that has already occurred in the emerging market economies?

Many U.S. investors treat emerging markets now much as their predecessors treated the developed markets in the early years of investing overseas. In the early 1980s, many investors primarily perceived investing in the stocks of developed countries as a strategy which added risk and occasionally might bolster returns. By the 1990s, however, many of these investors had moved to embracing non-U.S. stocks as a core portion of their diversified portfolios due to the demonstrated ability of these investments to enhance their risk-return profiles.

Today, many institutional investors are increasing their allocation to international equities in general to more closely represent this asset class's economic import relative to U.S. stocks. In addition, many investors are beginning to make long-term commitments to investing in emerging markets, as the same arguments that were made regarding non-U.S. equities a generation ago – superior growth opportunities and overall portfolio risk reduction – have been borne out.

What would you say underlies that?

We may be witnessing the beginnings of a shift in global economic leadership akin to the process that made the U.S. the world's greatest economic power in the Twentieth Century. The U.S. has taken on huge commitments over the past generation – similar to the burdens of empire that the world's previous economic leader, the U.K., faced at the dawn of World War I. At that time, the greatest emerging market of the era, the U.S., began to exercise its economic and po-

litical will as the old guard became increasingly toothless. This process continued uninterrupted through the financial upheaval of the 1930s. By the end of World War II, the preeminence of the U.S. was unquestioned.

A similar shift in economic positions may well be taking place now. Although the U.S. economy and the U.S. dollar are still the backbone of the global financial system, China's economic clout is rapidly expanding across the globe. It is clearly on a path to share preeminence with the U.S. in generations to come.

More generally, two major factors should contribute to the long-term success of today's emerging markets:

1. Favorable Demographic Trends: The burden of an aging populace with fewer workers to support retirees is most acute in the developed world, most clearly in Japan and Germany, less so in the U.S. (where immigration and relatively high fertility rates have helped keep the population relatively younger). Emerging Asia, on the other hand, is currently in the favorable position of having many working age people relative to retirees. This should remain true in China for another generation and even longer for the rest of the region. Eastern Europe also has a slightly younger population than the European Union, bolstering the long-term growth prospects for these emerging markets.

2. Healthy growth with low leverage: Over the last decade, the emerging markets have shown increasing prudence in fiscal and monetary affairs. Debt-to-GDP ratios, which have reached approximately 100% for the G-20 developed nations, stand below 40% for the emerging world. By many measures, this fiscal conservatism has allowed the emerging markets to weather the current storm much better than the developed markets. With growth in the largest emerging market, China, forecast to quicken in the second half of the year, emerging markets as a whole may deliver positive GDP results for 2009.

We may be witnessing the beginnings of a shift in global economic leadership.

Emerging markets, wave of the future? (continued)

While the developed world has grown largely on the back of increasing leverage for the past decade, the growth from the emerging world appears more sustainable. It is less likely to be impacted by the deleveraging process that the U.S. and Europe are currently experiencing.

Improved governance and economic liberalization are occurring in places like Brazil that until recently seemed doomed to chronically mismanaged affairs at the corporate and governmental levels. Finally, the political turmoil experienced by fledgling democracies like Turkey, Thailand and Malaysia hasn't upset the movement toward more liberal financial markets and healthy growth.

Should we think of emerging markets homogeneously?

Definitely not. Development is being driven by different factors in different regions. As an example, let's look at the differing experiences of Asia and Eastern Europe.

Much of Asia's growth is being driven by rapid development in China. That development, while impressive, still has a long way to go before China becomes a truly wealthy nation by Western standards. In response to the current crisis, many Asian emerging markets are seeking to decrease their dependence on exports and to focus on generating domestic demand. This change should prove a stabilizing force in the volatility of their economic performance over the long term.

From the political side, we are unlikely to see a united Asian bloc in the near future. Despite China's increasing importance, historical animosities, shifting allegiances and dramatic differences in wealth should keep economic power rather broadly dispersed. Generally, this is likely a positive for foreign investors who benefit from investing among nations at different stages in their economic cycles.

What about the emerging markets of Eastern Europe?

It is dangerous to consider all of Eastern Europe as one block; the challenges it faces will have greatly differential impacts on the individual states. Nevertheless, Eastern Europe as a whole is caught between two competing forces – the nationalistic ambitions of an increasingly autocratic Russia and the attractions of European Union.

Today's Russia is not the Russia of Gorbachev. The institutions of government (outside the executive branch) are weaker, the executive branch is more powerful and more corrupt, the nation as a whole has turned dangerously nationalistic, and the wealth of the recent energy boom has been squandered without improving the lot of the populace. Russia's belligerence tends to increase with the prices of oil and (more importantly) natural gas. To the extent that Russia sees its ex-Soviet states and other Eastern European countries as pawns in a battle with the West, a degree of instability is unavoidable.

Offsetting Russia's influence is the pull of the European Union (EU). The speed with which many Eastern European markets have moved toward EU membership has been remarkable. This trend will likely prove both a strain and a boon, as growing wealth in the East is a source of demand for the West while labor from the East puts pressure on the Western European markets.

Growth from the emerging world appears more sustainable.

The U.S. is likely to experience a slow growth recovery

The debate for investors should not only be about the timing of the recovery but its strength as well.

Final first quarter GDP showed a decline of -5.5%, following a -6.3% drop in the fourth quarter of last year. The consensus forecast is that GDP fell another -2.0% in the second quarter, that the third quarter will be flat and that the fourth quarter will be up 2.0%. This outlook feels a bit optimistic to us given the economic evidence that has been reported so far. In fact, although we agree that the U.S. will most likely experience a slow growth recovery, we believe the downside risks have increased and that the recovery could be pushed back to early next year.

However, the debate for investors should not only be about the timing of the recovery but its strength as well. This is not a normal economic cycle. Unlike a typical recession, the current recession was caused by a financial panic coming out of a period of sustained overconsumption. The bursting of the housing bubble and the stock market correction have done damage to consumers' balance sheets, and it will take time for those balance sheets to be repaired. Other recent developments have the potential for adversely impacting the long-term growth potential of the economy. Under these circumstances, the recovery may very well be less robust than many expect.

Where Are We Now?

Consumer spending in April and May ran below its first quarter average and is likely to subtract from GDP growth in the second quarter after adding 1% in the first quarter. Personal income growth increased at a 7.2% annualized pace for the three months ending in May. Unfortunately, all of the increase was due to a one-time \$250 transfer payment to Social Security recipients under the American Recovery and Reinvestment Act. The wage and salary component of personal income declined by -3.2% over the same three-month period.

Since employment is continuing to shrink rapidly, wage growth is declining and net worths have been hit hard by the drop in the housing and financial markets, consumers are likely to continue to retrench and rebuild their balance

sheets. This is what led the savings rate to rise from 0% in 2007 to 6.9% in May. The current savings rate is about in line with the post-World War II average, but consumers are likely to overshoot until their balance sheets get into better shape.

Housing remains a big problem. Although housing affordability is still near record highs, a sustained increase in home buying is unlikely until home prices stabilize, job security improves and banks become more willing to lend. In addition, with mortgage rates rising, we have seen a sharp drop in mortgage refinancing. According to the Mortgage Bankers Association, applications for refinancing have fallen 80% from the highs set in March. Purchasing activity has been a bit better, but at best it is stabilizing at a very low level. With foreclosures still running at over 300,000 per month and the inventory of unsold homes still near record highs, the downward pressure on home prices remains strong, creating a "wait to buy" attitude for many potential home buyers. The S&P/Case-Shiller 20-City Home Price Index fell for the 33rd consecutive month and has now fallen 32.6% from its July 2006 peak.

The manufacturing part of the economy seems to be improving, with the regional purchasing manager surveys and the National Institute of Supply Management Survey rising. Although not as bad as they were, these indices are still at contractionary levels. Industrial production continues to decline, reaching new cyclical lows every month. As a result, the capacity utilization rate has dropped to a post-World War II low of 69.4%. Until this excess capacity is absorbed, capital spending is likely to be a drag on growth.

Inventories also continue to weigh against growth. Although inventories have fallen sharply, they remain high relative to sales. Unless sales begin to accelerate, companies are likely to cut production to bring inventories back into line.

Net exports have contributed positively to economic activity but for a perverse reason. The

The U.S. is likely to experience a slow growth recovery (continued)

severity of the recession has caused imports to shrink faster than exports. The trade deficit did widen in April as exports fell faster than the decline in imports. Falling exports reflect weaker global economic activity, while falling imports reflect weaker domestic activity. Over the next couple of months, the trade deficit is likely to widen further as the recent oil price spike increases the value of oil imports. A wider trade deficit puts downward pressure on GDP.

Despite an almost \$800 billion stimulus plan, government spending has yet to spark much economic activity. Most of the stimulus was back-end loaded and won't hit until 2010 and 2011. In addition, the "shovel ready" infrastructure projects were not as "shovel ready" as expected; many have been delayed due to the normal planning and environmental impact review process. Finally, state and local governments are cutting back faster than the Federal government can spend.

What Could Go Right?

Economic growth could be stronger than expected. Historically, the strongest periods of economic growth are the first few quarters coming out of recession. A slow growth recovery is not the norm.

The preconditions for growth are also in place. The Fed is aggressively easing, interest rates are low, the yield curve is positive, banks are currently well capitalized, credit markets have stopped deteriorating, and fiscal policy could provide at least a short-term boost to growth. In addition, housing affordability is at near record levels. If the negative psychology surrounding housing can be broken, activity could increase. Simply stabilizing at a low level would remove an important drag on growth.

Asia in general and China in particular seem poised for stronger growth and an upward revaluation of their currencies. If that is the case, American exports could benefit. Stronger Asian currencies would make U.S. exports more competitive. Asia is trying to shift from an export driven mercantilist economy to a more balanced

domestically driven economy. As this region builds out its middle class, the market for higher value added goods should increase.

Finally, many market indicators are suggesting the worst is over and the next up-cycle may be at hand. Stock prices, the best leading economic indicator, have risen sharply from their March lows. Corporate credit spreads have narrowed significantly, and the VIX (volatility) Index has declined sharply, indicating that investors have begun to take on more risk.

What Could Go Wrong?

The housing bubble may not be fully deflated. Home prices could fall another 15% to 20% to get back to the long-term trend (i.e., the price levels we would have seen if, during the bubble, home prices had only increased at their long-term rate of 0.5% faster than inflation each year). While the bulk of the subprime mortgage resets that triggered the current round of foreclosures is behind us, another tsunami of mortgage resets will hit later this year and into 2011. Many of these mortgages are Option ARMs (adjustable rate mortgages giving the borrower different payment options) and Alt-A loans (medium-grade quality mortgages). With more and more homeowners owing more than they own, the temptation to walk away from these loans will be strong, particularly for speculators. In addition, as these loans come due, difficulties in obtaining refinancing may leave some homeowners little choice but to walk away. The default rate on Alt-A loans is already 20% and is likely to go higher. Credit Suisse estimates that about half of the \$2.4 trillion in outstanding Alt-A loans will reset in the next two to three years.

Commercial real estate, like every other sector of the economy, has deteriorated significantly as vacancies and rents have declined. As a result, property values have fallen and many properties are underwater. If distressed sells accelerate, the debt behind these properties could become an issue.

Continued problems with residential and commercial properties raise the risk of banks having

Many market indicators are suggesting the worst is over.

The U.S. is likely to experience a slow growth recovery (continued)

to increase their writeoffs for bad loans. Credit card losses are also increasing. It is therefore understandable that banks are hoarding capital and being cautious in making new loans.

Longer term, the U.S. runs the risk of committing what our Chief Economist calls the “Five Deadly Economic Sins”:

1. Excessive monetary creation which, if sustained, could cause a decline in the dollar and an increase in inflation.
2. Excessive government spending and debt, which go hand in hand with excessive money creation. According to the Congressional Budget Office, government spending as a percent of GDP will climb from 20% in 2008 to almost 25% in 2019. Over the same time period, government debt is projected to rise from \$5.8 trillion to \$17.3 trillion as deficits accumulate.
3. Excessive taxation, which can reduce long-term growth. At some point, if you tax something (like income or capital investment) too much, you get less of it. Income and capital gain taxes are already set to rise at the end of 2010 when the Bush administration’s tax cuts automatically expire. The recent up-tick in oil prices to above \$60 per barrel is a de-facto tax that is reducing consumer purchasing power. If the Cap and Trade legislation passes, a hidden tax will be seen in the price of most things produced in this country.
4. Regulation is an attempt to close the barn door after the horses are gone. We are currently seeing one of the greatest expansions in regulation and government intervention in this country since the Great Depression. The government has taken over much of the auto industry, is increasing regulations on the financial sector and wants to take over a big portion of the healthcare industry that it doesn’t already control.
5. Protectionism is the final deadly sin. We are starting to see more tit-for-tat protectionist measures that weaken global economic trade at the very time we need to strength-

en global trade. A provision in the recently proposed Cap and Trade legislation would impose a tariff on imported goods from countries that don’t match U.S. efforts to combat global warming. Whether you think this is a good or bad idea, it is not sitting well with China and India and could trigger a trade war.

In addition, the looming Social Security and Medicare funding problem, the underfunded pension liabilities of state and local governments, the massive budget deficits in many states, the potential problem with Eastern European debt and the fragile geopolitical situation all increase the downside risks to the economy.

Why Forecasting Is Difficult

What makes forecasting difficult is that many of these risk factors impact the long-term growth potential of the economy, which tends to be less important to financial markets than shorter term factors. For example, during the inflationary, rising interest rate and slower real growth environment of the 1970s, the stock market went nowhere for a decade. However, during this same period, the S&P 500 experienced two sharp declines of -36% and -48% as well as two rallies of over 70% each. Even during the Great Depression, the U.S. stock market had numerous counter trend rallies and a powerful rally off the bottom before settling into a volatile trading range. There can be opportunities even in adverse economic periods as the economy struggles for a new equilibrium.

We believe America is not finished; it is just off track. Business cycles will continue and eventually the structural problems will be resolved. Balance sheets will be deleveraged, savings will be rebuilt, home prices will reach equilibrium, and bank writedowns will end.

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Growth in Asia is likely to drive the international economic recovery

Big bear markets take place for a reason – to adjust structural imbalances in an economy. The structural imbalance that built up in the global economy during the last decade was the overstretching of the American consumer, whose spending was the foundation of global growth.

As consumers over spent, the U.S. savings rate fell to zero, its trade deficit ballooned, and consumers borrowed heavily, collateralized first by a stock market bubble and then by a housing bubble. Government sponsorship of housing and the acceleration in government spending artificially supported growth. The spending was funded by surging tax revenues from a strong economy, capital gain tax revenues from the stock bubble and property taxes from home price appreciation. The bounty of tax revenues was leveraged by high budget deficits.

Shift in Source of Global Growth

The global economy can no longer expect the American consumer to drive growth. Instead, the global economy has to look to the East. Asian central banks and politicians appear to understand this. They are moving away from a mercantilist model of export driven growth toward building out their own economies to develop domestic demand generated growth. One of the key factors to watch will be whether these Asian countries allow their currencies to appreciate and avoid policies that keep currency values low to support exports.

Asia

After the Asian currency crisis in the late 1990s, Asian countries learned the lesson that an overvalued currency can lead to current account deficits, reserve outflows from central banks, excessive speculation and eventual massive devaluations as bubbles burst. Determined not to let their currencies become overvalued, they spent the last decade keeping currencies undervalued to promote exports to the detriment of internal consumption. This policy led to massive trade surpluses and capital inflows into central banks. The capital inflows in turn led to accumulation of U.S. and other Western debt.

This currency policy worked well until quite recently. Asia met Western consumers' insatiable demand for cheap goods by both producing those goods and providing the capital which would allow the West to continue to buy those goods. Now, with the U.S. consumer deleveraging, rebuilding balance sheets and increasing savings, the vulnerability of export driven growth has become apparent. To diversify away from this type of growth, Asia needs to boost domestic demand, which means it must increase consumption and reduce savings.

Fortunately, a number of structural changes are taking place that do just that. People tend to save when incomes are uncertain or they have inadequate safety nets. As Asian economies have become more industrialized, the need for savings has decreased. Asian economies are now much less dependent on agriculture, one of the most uncertain economic endeavors since output is driven by the whims of the weather. Moreover, Asian countries are just beginning to provide their citizens with safety nets, reducing another need for savings. Over the last few years, China has spent large sums of money on healthcare and education. The clear aim is to provide a safety net that would allow individuals to accumulate less precautionary savings and to consume more. The other form of safety net is private insurance for health, property and life. The insurance industry is just starting to become established in many of these developing countries.

Asia is in an attractive economic position. The countries in this region have large capital reserves and relatively young and growing populations. Asia has an abundance of capital and labor, the two main ingredients for economic growth. Asia is expected to grow from its current 27.5% to 50% of global GDP over the next twenty years.

Europe

Europe faces many of the same problems as the U.S. Economic activity continues to decline, unemployment is rising sharply, and consumers are deleveraging. Despite some signs that

Growth in Asia is likely to drive the international economic recovery (continued)

European economic activity has bottomed, it is unclear whether a true recovery has begun or whether the region has merely entered a less severe recession.

The Eurozone also faces the risk that it may have to absorb defaults on the euro-denominated loans made to some of the weaker government borrowers on its periphery. Germany and the rest of the Eurozone have become increasingly dependent on exports to Eastern Europe, and European banks are heavily exposed to Eastern European debt. If Eastern European currencies begin to weaken, the ability to repay these debts could be impaired. So far, these currencies have held up reasonably well, and support from the International Monetary Fund (IMF) could avert a collapse. A shock in this region would be one that the Eurozone could do without.

Despite some signs that European activity has bottomed, it is unclear whether a true recovery has begun.

U.S. bonds generally fared well in the second quarter

U.S. bonds generally fared well in the second quarter, with the best returns accruing to sectors entailing some measure of credit risk. The broad-based Merrill Lynch U.S. Corporate, Government and Mortgage index returned 1.5% for the three months. High yield debt, as measured by the Merrill Lynch High Yield Cash Pay index, turned in the best result in its history, advancing 22.5% for the quarter. Investment grade corporate bonds also performed well; the Merrill Lynch Corporate Master index's 10.8% return was that index's best quarterly result in more than 25 years.

U.S. Treasuries, whose yields had reached extremely low levels, sold off as investors sought greater risk. The broad-based U.S. Treasury Master index lost -3.1% in the second quarter. Longer maturity Treasury issues fared even worse, with the Merrill Lynch U.S. Treasuries 10+ Years index falling -7.2% for the period.

Of primary focus for many investors was the municipal bond market, which staged a rally despite the growing difficulties many states are having in balancing their budgets. For the quarter, the Merrill Lynch Municipal Master index returned 2.7%.

Impact of State Deficits

Unlike the Federal government, states can only finance spending with revenues and the issuance of debt. The Federal government's unwillingness thus far to implicitly support state finances, coupled with the dramatic economic slowdown nationwide and the even more extreme experiences in selected areas, has pushed some state budgets past the breaking point. California has been forced to issue IOUs for many of its commitments as the budget stalemate remained unresolved at quarter's end. With the third highest unemployment rate in the country, ratings agencies have put the state on watch for further credit downgrades. Nevertheless, we believe the risk of outright default remains low, as such an action would shake the foundations of the municipal bond market. A loss of confidence in that arena would likely result in a crisis on the order of last fall's demise of Lehman Brothers.

Corporate Yield Spreads

On the corporate side, credit spreads for speculative and investment grade debt contracted remarkably during the quarter. High yield spreads, which peaked at 2,178 basis points (21.78%) over Treasury yields last December, ended the quarter at 1,074 basis points (10.74%). Similarly, investment grade yield spreads have declined from 656 basis points (6.56%) to 331 basis points (3.31%) over the same time period. Investors have likely pushed spreads narrower than warranted by the economic environment; we believe we are likely to see an acceleration in defaults both in corporate and mortgage debt in the second half of the year.

Foreign Exchange

Since early last summer, one of the hallmarks of this global crisis has been a strengthening U.S. dollar, as both the greenback and the Japanese yen were deemed to be "safe haven" currencies amidst the storm. That stream of money has propelled short-term Treasury yields to microscopic levels; the yield on one-year Treasuries has fallen from 2.4% last summer to 0.5% today.

In the second quarter, this foreign exchange trend reversed dramatically as the dollar declined relative to all major currencies. The greatest strength was seen in commodity-based currencies and the British pound (all generally rising between 10% and 25% versus the greenback). The yen lagged the group as a whole, rising only 3.2% versus the dollar.

U.S. Treasuries sold off as investors sought greater risk.

U.S. stocks rallied in the second quarter

The second quarter of 2009 gave investors something they hadn't seen in a while – positive U.S. stock market returns. The S&P 500 index rose +15.9%, the NASDAQ 100 index climbed +19.6%, and the S&P Small Cap 600/Citigroup Value index advanced +20.6%.

Falling 50% and then subsequently rising 50% does not get one back to break-even.

This stock market rally actually began on March 9th. From that trough to the most recent peak in June, the S&P 500 is up 39.9%, and small value stocks are up an even more impressive 55.5% (as measured by the S&P Small Cap 600/Citigroup Value index). These are handsome gains, but, as we all remember from math class, falling 50% and then subsequently rising 50% does not get one back to break-even. The S&P 500's -56.8% drop from its bull market high, coupled with its recent 39.9% gain, still leaves it -39.6% below its 2007 peak. Similarly, the S&P Small Cap 600/Citigroup Value index's -61.58% fall and 55.5% rebound places it -40.3% below its 2007 all-time high.

Will Stocks Continue to Rally?

So, are stocks ahead of themselves after rallying 40% or more over the last four months, or are they just getting started, still 40% below their bull market highs? It is not easy to answer this question in the short term.

Right now, the economy is weak and the prospects for recovery uncertain. Fear of inflation is legitimate and rising. In addition, government policy often seems misguided, with the potential to make existing problems worse. For students of history or those of us old enough to remember, this all has a familiar ring. It sounds very much like the mid-1970s. Through much of that decade the stock market was essentially flat, stuck in a trading range over a multi-year period. However, it did experience several significant bull and bear market swings, including two rallies of over 70% each.

Markets tend to climb “walls of worry”, and, as mentioned above, there remains plenty to be worried about. While the recent market gains have been impressive, we are still far below the highs of 2007, and historical periods similar to

today have produced significantly larger gains without a correction. Investor sentiment, which is currently mixed, is typically much more bullish at market tops. Valuations, while no longer at the extreme lows experienced last winter, are by no measure high or worrisome in and of themselves.

Long-Term Outlook

When speaking of democracy, Winston Churchill said that it is “the worst form of government except all the others that have been tried.” It is important to not lose sight of the fact that, over the long term, the U.S. stock market has historically provided positive after-tax, inflation adjusted returns. Bonds can't make that claim. Neither can cash. Historically, real estate is a viable though less liquid alternative; however, it is facing its own troubles over the short to medium term. So, for almost any scenario short of the end of the world, we believe that stocks, with all their faults, provide the best hope for long-term investment success.

International stocks also rallied during the quarter

International stocks participated in the rally that drove U.S. stocks higher during the second quarter. While the returns were similar on a local currency basis, dollar weakness added to international stock returns. The MSCI All Country World ex-U.S. (U.S. \$) international stock index advanced 27.6% for the quarter, while the developed subset of that index, the EAFE, rose 25.4% in U.S. dollar terms. No major world market turned in negative results when measured in dollars. The best performing countries – Hungary, India, Turkey, Indonesia, Thailand and Colombia – each returned more than 50% in U.S. dollar terms (as measured by their respective MSCI country indices).

The G-20 meeting in early April gave confidence to the market that capital was available through the IMF to help support debt-ridden markets in Eastern Europe. Marginalized by many of its major funders for the past decade, the IMF has been given new importance by commitments of \$750 billion. In addition, the organization does not seem to be repeating past mistakes, such as imposing burdensome anti-growth fiscal constraints on borrower nations.

Impact of China's Growth

Contrary to earlier forecasts for slower growth, China's economy is likely to expand at a 9% rate in the second quarter of 2009. This resurgent growth looks like a boon to China's Asian neighbors. The combined Hong Kong and China bloc is the most important export market for Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. Export-dependent markets are already feeling the effects; Korea's trade balance has returned to a surplus, largely due to Chinese demand.

Interest rate uncertainty is high, leading to greater scrutiny of government debt levels. By this measure, the U.S. and the major players of Western Europe appear to be at a disadvantage relative to the smaller countries of Western Europe and to emerging markets generally.

While international equity returns were strong in the second quarter, they may be getting ahead of economic reality in many markets. It is difficult to rely on valuation measures at a point in the earning cycle when results are generally negative, but, by and large, valuations don't look exceedingly cheap. Given the difficult road that remains for recovery, international stocks may retrace some of the second quarter's gains but continue to provide opportunities for attractive long-term investment.

Dollar weakness added to international stock returns.

Looking Forward

Commercial real estate continues to deteriorate

We're still being disappointed on the downside.

The second quarter of 2009 witnessed another precipitous decline in commercial real estate values, with the NCREIF NPI index estimated to have declined by over 19% in just two quarters. Commercial real estate continues to be impacted by both: 1) deteriorating operating fundamentals in the form of decreasing market occupancies and rents; and 2) a repricing of risk resulting in higher required returns for the asset class. These forces have significantly impacted property valuations, which are based in part on assumptions about market rents, rent growth, down time between leases, tenant improvement allowances, vacancy, cap rates and IRRs (internal rates of returns). Small movements in each of these factors can have a large impact on values.

Investors are wondering when all the write-downs will end. Values will likely improve before fundamentals, since property appraisals include projections for fundamentals. However, while much “bad news” has already been baked in to today’s valuation assumptions, we’re still being disappointed on the downside (analogous to negative earnings surprises in the equities market). In addition, values are unlikely to stabilize until there is a liquid market for property sales and transaction volume increases. The stalled sales market is in part due to the ongoing credit crisis in commercial real estate.

How Bad Will It Get?

No one knows for sure how bad it will get. Many estimates are for a 40%+ peak-to-trough decline in gross asset values, but it could be more. At some point though, the magnitude of the declines in values should make commercial real estate incredibly compelling compared to other asset classes. New capital would then likely flow into the asset class, putting a floor on further declines.

Commercial real estate is experiencing a significant repricing that has affected all markets and property types and even the most conservatively positioned portfolios. Some commercial real estate funds with no equity left are trying to restructure or are going bankrupt. Many funds

have already handed properties back to lenders.

Long-Term Benefits

With all the bad news, it is easy to lose sight of the benefits of remaining invested in commercial real estate. Rather than selling at the bottom of the market, we believe it makes sense to ride the recovery in prices and fundamentals. Price declines are likely to provide very attractive income yields going forward and a cyclical buying opportunity akin to that of the early 1990s. Lastly, real estate can act as a hedge against inflation when property owners are able to pass cost increases through to their tenants.

We have reduced our U.S. equity exposure

During the quarter, we allowed our equity allocations to drift higher as the global stock markets rallied. In June, we removed the upward drift in the stock portion of the portfolio and reduced our allocation back to guidelines. In the first part of July, we reduced our U.S. equity exposure even further.

U.S. Stocks: Underweight

The U.S. stock market appears to be discounting an economic recovery beginning later this year. While that is our base case (i.e. most likely economic scenario) as well, we believe the probability of the recovery being pushed into 2010 is increasing. We also see a number of risks as outlined in the economic section of the newsletter that could make the downturn deeper and longer. Our risk assessment of the Prolonged Recession Scenario has increased from 25% to 35%. The probability of the Growth Spurt Scenario has diminished from 25% to 20%, while the odds of our base case Gradual Recovery Scenario have decreased from 50% to 45%. With the stock market well off its lows and starting to discount an end to the recession, unless the economic data catches up with expectations, stock prices could be vulnerable. The fact that this is not a “normal” economic cycle is adding to the haze. At this point, we believe risk reduction should take precedence over return maximization.

International Stocks: Neutral

We have continued to let our international stock portfolios drift higher. While foreign markets will not be immune to a market downturn in the U.S., we want to be more diversified across countries due in part to the risk of a weaker dollar. The massive expansion in U.S. government spending and debt along with substantial holdings of U.S. debt by foreigners raises the risk of a “buyer’s strike” which could send the dollar lower. International stocks would act as a hedge against such a dollar decline.

Bonds: Underweight

Ten-year U.S. Treasury bond yields, after rising 50 basis points (0.5%) in the first quarter, increased another 150 basis points (1.50%) during the sec-

ond quarter to peak at 4.0%, before falling back to 3.5% at the end of June. The Treasury market, like the stock market, is starting to discount a bottoming of the recession. Treasury bond yields, although moving higher, remain too low. We believe a fair value yield on the ten-year Treasury is closer to 5.5%. Given today’s deflationary environment, yields are unlikely to move significantly higher in the short term. However, coming out the other side of the recession, yields are likely to spike as the Fed tries to remove stimulus from the economy before it becomes inflationary. In addition, given the Congressional Budget Office’s projections of outsized 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.

Real Estate: Neutral*

Commercial real estate returns continued to give way under the weight of a very difficult economic and financial environment. In addition to a more difficult operating conditions, capitalization rates have risen as well. Both factors are weighing on returns. As long as the economy remains weak, the environment for commercial real estate will remain challenging.

Alternative Investments*

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.

At this point, we believe risk reduction should take precedence over return maximization.

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U.S. INTEREST RATES	9/30/2008	12/31/2008	3/31/2009	6/30/2009
Cash Equivalents				
90-Day Treasury Bills	0.92%	0.09%	0.21%	0.20%
Federal Funds Target	2.00%	0.25%	0.25%	0.25%
Bank Prime Rate	5.00%	3.25%	3.25%	3.25%
Money Market Funds	2.25%	2.29%	0.72%	0.29%
Bonds				
30-Year U.S. Treasury	4.31%	2.68%	3.54%	4.33%
20-Year AA Municipal	5.14%	5.21%	4.93%	4.84%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 6/30/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 Year Treasury Index	-5.02%	-6.25%	7.57%
Merrill Lynch 7-10 Year Agency Index	-0.99%	-1.98%	9.37%
Merrill Lynch 5-10 Year Corporate Index	11.51%	10.88%	1.24%
Barclay Capital Municipal Bond Index	2.11%	6.42%	3.77%
International Bonds			
Citigroup non-US\$ World Government Bond Index, fully hedged	0.16%	0.21%	8.54%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 6/30/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	11.96%	-1.97%	-22.97%
S&P 500	15.92%	3.19%	-26.20%
NASDAQ 100	19.63%	22.41%	-19.02%
S&P SmallCap 600/Citigroup Value	20.59%	-2.04%	-24.32%
International Stocks			
MSCI Japan, net dividends	23.05%	2.59%	-23.12%
MSCI Europe (includes UK), net dividends	25.26%	7.03%	-34.53%
MSCI EAFE (Europe, Australia, Far East), net dividends	25.43%	7.95%	-31.35%

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

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 6/30/09	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-11.00%	-17.52%	-24.49%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is lagged by one quarter.

Past performance is no guarantee 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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