

BAILARD INTERVIEW

Questions for Our Chief Economist

In this interview, Chief Economist Art Micheletti answers questions about the current investment markets, Bailard's investment strategy and the outlook for the future.



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Chief Economist and Investment Strategist

You have been cautious on stocks for most of the year and stocks have continued to move higher. It seems like the market is seeing something you aren't. What has you worried?

I continue to see the economic environment as one with a number of very big risks. At the top of the list are four looming waves of debt – residential mortgage resets, maturing commercial real estate and corporate debt, and expanding government budget deficits - that will need to be financed next year. This tsunami of debt is coming at a time when the dollar continues to weaken and domestic savings remain quite low, putting us potentially at the mercy of foreign investors. Pending tax hikes, increased regulation and creeping protectionism are also risk factors.

All of this is generally known but the market keeps moving higher. Why?

Early in the year, the U.S. stock market became deeply oversold as it started discounting the risk of a full-blown economic depression. This made it ripe for a rally. The market started moving higher on short covering as investors with big bets on a down market (particularly on bank stocks) were forced to cover their short positions. One of the triggers for the short covering was an end to mark-to-market accounting, which gave banks greater leeway as to how to account for the toxic assets on their books. The lowest quality stocks

continued on page 2

IN THIS ISSUE

U.S. Economy 4
Although still very depressed, the U.S. economy is likely to see positive growth in the third quarter.

International Economies 5
International economies also appear to be recovering.

Fixed Income/Foreign Exchange 6
Domestic bonds rallied in the third quarter, while the U.S. dollar remained in a decline.

Domestic Equities 7
U.S. stocks continued their powerful rally off the market bottom, with low quality companies outperforming their higher quality counterparts.

International Equities 8
International stocks also rallied due to decreased risk aversion and early signs of economic recovery.

Real Estate 9
We discuss a three-stage solution to commercial real estate's debt problem.

Bailard Investment Strategy 10
In July and again in early October, we reduced stocks to remove the portfolio drift that occurred as the stock market surged forward.

Market Performance 11

Questions for Our Chief Economist (continued)

continued from page 1

that were beaten down the most were driven higher and carried the whole market up with them. Then we started to see indications that the economy was bottoming. Corporate profits also came in better than expected for the second quarter. The stock market, which tends to discount events six months in the future, continued to rally in anticipation of an economic recovery.

So what's not to like?

First, a lot of the economic improvement is artificial, stemming from government incentives for home and car buyers. The real economic numbers are still anemic. The labor market remains extremely soft, while home foreclosures and delinquencies continue to rise. In addition, the market is now discounting a sustained economic recovery. While I have a great deal of respect for the collective wisdom of investors and believe the stock market is one of the best economic forecasting tools, stocks would be vulnerable if a sustained recovery does not develop.

You mentioned earlier that the shift from mark-to-market accounting helped stabilize bank earnings. Does that mean that bankings' problems are over?

No. Last year, I argued that mark-to-market accounting unrealistically devalued certain assets by forcing them to be priced at distressed levels. Now the pendulum has moved to the other side, where banks are hiding toxic assets by recategorizing them as level 3 assets, which allows them to hold these assets at cost. Given the potential risks I outlined earlier, loan losses are likely to remain a problem for banks. This is one of the reasons that banks have been reluctant to lend money. They are continuing to see pressure on their capital ratios.

As a result of your cautious posture, you are recommending holding a significant amount of cash equivalents. What are your plans for reallocating that cash?

We are holding cash, not because we see it as a great investment, but because other traditional assets used to hedge stock market risk are unattractive. Bond yields are extremely low and offer little value to investors. Corporate bond yields in particular have fallen sharply as credit spreads have narrowed. If this recovery is for real, infla-

tion expectations are likely to rise, which should lead to higher yields and lower bond prices. Even real estate, which was such a great hedge against stock market volatility over the last fifteen to twenty years, has not been able to escape this down cycle. Potential uses for the cash include Treasury Inflation Protected Bonds (TIPs), gold and shorter term bonds. The real purpose of the cash is to take advantage of opportunities as they present themselves. If stocks were to pull back significantly, we will likely put some of this money back to work. We expect the future environment to be volatile, with big ups and downs and plenty of opportunities.

Given the sharp drop in commercial real estate, could this be a potential use for cash?

Although valuations have improved significantly and the relative value compared to stocks and bonds is getting better, I do not believe this is the time to venture more heavily into commercial real estate. The market environment remains very shaky, with a lot of downward pressure on prices as distressed sales continue to increase. A number of vulture pools are being formed to take advantage of distressed sales, but they have yet to step up in a meaningful way. We believe one sign of a market bottom will be when money from the vulture funds starts to flow into commercial real estate.

How worried should we be about inflation, given the amount of liquidity the Fed has pumped into the system?

Currently, I am more concerned about deflation and continued economic weakness than inflation. However, inflation is always and everywhere a monetary phenomenon. Although the Fed is providing the economy with a great deal of liquidity, inflation is currently not a problem because this liquidity is not translating into stronger growth or bank lending. The velocity of money (i.e. the number of times it turns over) is also continuing to decline. When the economy does recover, the Fed will have to scramble to drain excess liquidity from the system or there will likely be inflationary consequences. To drain the excess liquidity, the Fed will have to sell all the marketable securities that it has acquired over the last year. This could be difficult to do given that the Fed will be competing with the U.S. Treasury to sell debt, which could push rates

Questions for Our Chief Economist (continued)

higher and truncate the recovery. The Fed has been a willing buyer of Treasury and agency debt, which is another way of saying that it has been printing money, which in the long run will be inflationary unless that money is withdrawn from the system. Currently, the inflation is being felt primarily in asset (i.e., stocks, bonds, gold and oil) prices.

Why not raise more cash?

Our philosophy is not to deviate too far from our long-term strategic asset allocations. Over time, we believe a well diversified portfolio allows investors to participate during favorable outcomes and cushion the downside in bad times. Investors, particularly economists, need to be humble about their ability to forecast.

As I mentioned earlier, the financial markets tend to have the best forecasting record and currently the equity market is trending higher. In addition, stocks are fairly valued. Corporations have also been aggressive in cutting costs, so earnings could continue to provide positive surprises even in a slow growth recovery. I would also point out that there is still a lot of cash on the sidelines, and both individual and institutional investors have below average allocations to equities. With cash on the sidelines and the Fed continuing to pump liquidity into the system, there is plenty of fire power to push stocks higher.

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The U.S. economy, while recovering, faces risks

Our base case outlook is for a slow “stop and go” recovery.

Although economic data is improving off the bottom, it is still very depressed and risks over the next twelve months are high. Looming on the horizon are another \$350 billion in mortgage resets, a Federal budget deficit of well over \$1 trillion, state budget deficits of over \$150 billion, commercial loan refinancing of \$250 billion and corporate bond rollovers of \$200 billion. While the third quarter will likely see positive growth, that growth may not be sustainable, and the recovery is expected to be sluggish.

Labor markets remain softer in this cycle than in prior cycles; corporations have been very aggressive in slashing payrolls to improve margins and productivity. Layoffs, although lower than at the beginning of the year, remain at recession-like levels, with unemployment claims at over 500,000 per week. Continuing claims (the total number of people collecting benefits) are near the highs reached at the depth of the recession. These claims have stopped going up, not because people are finding jobs, but because they are running out of benefits. The Exhaustion Rate, a measure of the percentage of unemployed whose benefits run out before they find a job, moved to a new record high of 52% in August and is likely to move higher. Weak labor markets, increased job insecurity, tighter lending standards and the need for more deleveraging will likely restrain consumer spending for some time.

Housing and Autos

Housing and autos typically lead the economy out of recession. Both sectors remain under pressure despite massive amounts of fiscal stimulus. The “Cash for Clunkers” program is likely to provide only a temporary boost to sales, production and inventory rebuilding, as it only borrowed demand from the future and created no new demand. Housing activity remains depressed, albeit with some improvement in sales off the bottom largely due to a government sponsored \$8,000 housing credit for new home buyers. The existing supply of unsold homes is being supplemented by a large “shadow inventory” of homes being kept off the market by: 1) homeowners that want to sell but are reluctant to sell at low prices; 2) banks that are reluctant to foreclose and are trying to control the flow of foreclosures; and 3) loan modifications that are keeping homeowners (at least temporarily) in their homes.

Capital investment is likely to remain constrained by the lack of consumer demand and by low and falling capacity utilization rates. However, we are seeing significant improvement in the Purchasing Managers Surveys, which suggests that manufacturing is no longer contracting. Stronger than expected corporate profits could also support more capital spending. Credit markets have stabilized and borrowing costs have come down, which could help boost growth. Inventory disinvestment has reduced the unwanted inventory overhang. Although inventory disinvestment is likely to continue, it will probably be at a slower pace, which would lessen the inventory drag on growth.

Sustainable growth is unlikely until the consumer returns. Fiscal stimulus could help fill in some of the economic gaps in the short run, particularly since the bulk of the funds has not yet been spent. However, the stimulus program has caused the budget deficit to explode. As a result, foreigners may reduce their buying of U.S. debt, creating the risk of dollar devaluation and rising interest rates. The increase in taxes in 2011 is another potential risk, but we may have more time before it becomes an overriding concern.

Although it is too early to worry excessively about inflation, the Fed’s monetization of our debt makes it a risk longer term. Currently, the bigger risk is deflation and slipping back into recession.

The Argument for Stronger Growth

Our base case outlook is for a slow, “stop and go” recovery, with the risk being to the downside. However, growth could turn out to be stronger than expected. Positive growth over the next two quarters could rekindle consumer and business confidence, sustaining the recovery further. Improving confidence could increase spending, bank lending and job creation, and lead to inventory rebuilding. In addition, with housing affordability near record highs (due to low prices and mortgage rates), perhaps a sustainable housing recovery is closer than we think. Finally, the stock market, one of the best indicators of future economic activity, is currently discounting a sustainable recovery.

Led by China, foreign economies are beginning to recover

Given the strong headwinds faced by the U.S. economy, it is unlikely that the U.S. will be the locomotive for global economic recovery. The world can no longer count on the U.S. consumers' demand for foreign exports to fuel economic growth. As a result, foreign policymakers are working to encourage domestic demand and to move toward a better balance between internal and external sources of growth. As this occurs, economic leadership is likely to shift from the developed industrialized nations to developing countries.

Asia

During the second quarter, China's real economic growth accelerated to 7.9% year-over-year. With the leading economic indicators heading higher, growth is likely to remain healthy. Unlike in the U.S., China's fiscal stimulus was front loaded and targeted at enhancing infrastructure. As a result, China's economy has been more responsive to that stimulus. In addition, monetary policy has gained more traction than in the U.S. Although the Fed has aggressively provided liquidity to the banking system, bank lending in the U.S. has been all but nonexistent. In China, the banks do as they are instructed by the government. If they are told to lend, they lend. One concern is that, with growth recovering, the Chinese government may soon lean against this growth and call for lending restraint. In fact, the government has already restricted lending to cement and steel manufacturers facing a build-up in inventories.

While China would likely not be immune to the negative impact of a double-dip recession in industrial countries, it is in a more favorable long-term position. China is in much better shape demographically and fiscally than many developed nations. Countries, like China, with a large and growing labor force and excess capital, tend to have the best growth prospects.

At the other end of the spectrum is Japan. Its aging and shrinking labor force and heavily indebted economy suggest weaker relative long-term growth. Japan's economy is also struggling in the current environment. Although real GDP did grow at a 2.4% annual rate in the second quarter, nominal GDP declined -2.0% as the economy continued to deflate. The second quarter bounce in real GDP came after a -13.2% annualized drop

in the first quarter. Given weak employment and wage growth, plenty of excess capacity and relatively high inventories, the outlook is not encouraging. Exports and imports are flattening out, which suggest the economy may be bottoming; however, there are few signs that sustained growth is on the horizon. The strength in the yen may also hurt the economy by reducing Japan's competitive position and further impinging on export growth.

Europe

Although the EuroZone continues to struggle, the worst of the recession appears to be over. After declining at a -10% annualized rate in the first quarter, growth slipped only -0.4% in the second and is likely to be positive in the third. However, with fiscal stimulus running out and the European "Cash for Clunkers" programs expiring, growth may slow again in the fourth quarter. Retail sales and construction spending dropped to new cyclical lows in July. Auto registrations have also fallen sharply. Industrial production remains flat, despite an improvement in the Purchasing Managers Survey (PMI) which suggests that manufacturers are feeling better. The Business Climate Index has also turned higher.

There seems to be a growing divergence between real economic numbers and expectations. Both the Business Climate Index and PMI are September reports and are more current than the other data. Perhaps we will see an improvement in the real numbers in coming months. Although the outlook for Europe remains as hazy as that for the U.S., the worst is probably over.

The worst of the recession appears to be over.

U.S. bonds benefited from an increased appetite for risk during the third quarter

Yields fell across all fixed-income asset classes during the third quarter, led by corporate and municipal debt. The broad-based Merrill Lynch U.S. Corporate, Government and Mortgage bond index rose 3.6% for the period. Investment grade corporate and municipal debt, as measured by the Merrill Lynch Corporate Master and the Merrill Lynch Municipal Master indices, returned 8.3% and 8.1%, respectively. Increased risk-taking translated into better returns for the bond sectors most heavily hit in last year's financial tumult.

As global risk aversion fell, so did the U.S. dollar.

The strength of the corporate bond market has reduced credit spreads dramatically, enough in fact to take the pressure off the refunding concerns that existed six months ago. For high yield debt, the yield-to-maturity (a measure of current refinancing costs), which peaked last fall at 22.6%, has fallen to 10.1%. Similarly, the yield-to-maturity on higher quality, investment grade debt has fallen from 9.3% late last year to 5.0% at the end of this quarter. Moreover, according to Bloomberg, U.S. corporate debt issuance this year is ahead of the total for all of 2008. So, while bank lending remains stagnant, liquidity in the public bond markets is supporting a corporate recovery.

Municipal Debt

During the quarter, investors put aside concerns over states' and municipal entities' growing deficits. Instead, supply and demand were the primary drivers of municipal bond prices. With the exception of money market funds (whose below 0.1% yields led investors to seek higher yielding pastures), municipal bonds enjoyed strong demand. At the same time, issuance has been relatively low. About one-third of the current issuance is coming in taxable form – in Build America Bonds, backed (and subsidized) by the government – instead of the traditional tax-exempt structure. This combination of supply and demand has sustained a strong rally in municipal bonds this year even in the face of declining local revenues.

Foreign Exchange

As global risk aversion fell, so did the U.S. dollar. The “safe haven” currency of earlier this year is now being viewed as a place from which to borrow cheaply and deploy capital elsewhere. During the third quarter, dollar weakness was

generally broad-based, with the euro advancing 4.2%, the Japanese yen 7.4% and the Scandinavian currencies over 10%. The one exception to this trend was the British pound, which fell -2.7% versus the greenback.

The U.S.'s current excess capacity of both labor and capital implies little risk of near-term inflation and a relatively extended period of near-zero short-term interest rates. The prospect of relatively low short-term rates, along with the continued deleveraging of the U.S., should weigh on the dollar in the near term.

Regionally, there are several themes of import. We believe Latin American currencies are likely to experience upward pressure. This region never experienced as extreme an output gap as elsewhere. In addition, global demand growth could give further support to commodity prices, driving local governments to increase interest rates to moderate demand and making Latin American currencies more attractive from a relative short-term interest rate perspective. Policy-makers in Asia, by contrast, may seek to engineer weaker currencies as a mechanism to export their way out of the current downturn.

U.S. stocks experienced double-digit gains

History has shown that rallies off of a market bottom can be powerful in magnitude and also in length. The third quarter of 2009 will go down as yet another one of those powerful stock market rallies. All domestic stock indices were positive, with the S&P 500, the NASDAQ 100 and the S&P Small Cap 600/Citigroup Value indices up 15.6%, 16.6% and 20.1%, respectively, for the quarter.

2009 can be divided up into roughly two periods based on investor psychology and appetite for risk. The first quarter was characterized by extreme fear, panic and an overwhelming sense that the world was coming to an end. When it did not, the following two quarters were characterized by relief, which then led to a return in risk appetite. The almost six-month climb in the equity markets has continued, irrespective of what might lie ahead.

Similar to the second quarter, the winners in the third quarter were those companies that had previously been doomed to failure and death in investors' eyes. A more rational theme for investing is to look for those companies which have had, and will continue to have and grow, profits or earnings. The reason is that, as investors, we want to be paid back on our investment with earnings that are either: 1) paid out as dividends soon; or 2) reinvested in the business to help it grow so that more dividends can be paid later. Historically, we have seen periods in which investors ignore earnings, but it's usually never for long.

Low Quality Rally

The third quarter extended the second quarter's trend of rewarding companies with low quality earnings streams (or no earnings streams at all) at the expense of companies with higher quality earnings. It is never possible to predict when such a low quality rally can take hold, or, once it does, when it will end. It is possible, however, to state categorically that the low quality rally will end. Earnings are the ultimate source of stock returns. Investors shouldn't and won't forget that.

There are some indications to suggest that higher quality stocks may soon start performing better than their lower quality counterparts. The peak in credit spreads earlier this year coincided with a peak in fear and risk aversion. As spreads

started to narrow, lower quality stocks outperformed the higher quality ones. The spread between the Moody's Baa bond yield and the ten-year Treasury yield is approaching its 28-year norm, suggesting a stabilization in credit spreads. It is possible that this stabilization will result in higher quality companies performing better.

Preconditions for a Quality Rally

As we have discussed in prior publications, a sustainable quality rally typically can only take hold when we see positive revenue growth resulting in positive earnings growth. U.S. companies have shown positive growth over the last two quarters as a result of steep cost cutting measures, but not as a result of top line revenue growth. In order for this rally to be sustainable and meaningful, we believe we need to see a pick-up in inherent demand. When demand increases, those companies that have improved margins should outperform those that don't.

The winners in the third quarter were those companies that had previously been doomed to failure and death in investors' eyes.

International stocks also enjoyed double-digit returns

The economies that transition from recession to growth earliest and with the greatest sustainability should garner the greatest rewards.

Global stocks continued to rally in the third quarter, buoyed by decreased investor risk aversion and early signs that many economies around the world are emerging from recession. At quarter's end, our proprietary measure of global risk was at its lowest level since mid-2008 and near its average over the very long term. Both the developed and the emerging international stock markets fared well over the quarter, returning 19.5% and 20.9%, respectively, as measured by the MSCI EAFE and MSCI Emerging Market indices (U.S. \$, net dividends). These returns were enhanced by the decline in the U.S. dollar against most major currencies.

Although GDP growth and stock market returns aren't very correlated in the short term, the correlation tends to rise in periods of dramatic turning points like the global economy is currently experiencing. As economies around the globe transition from recession to growth, those that do so earliest and with the greatest sustainability should garner the greatest rewards. The process for this transition likely involves two steps: confidence that growth is returning and, later, that corporations are producing earnings growth.

Themes from the G-20 Meeting

The G-20 meeting at quarter's end made clear a couple of strong themes that affect global balances and growth patterns. Firstly, the G-8, which had previously been the primary global economic voice, has relinquished that role to the broader G-20, which includes a number of emerging markets. Their influence will now be approximately equal to that of the developed world, reflecting the emerging markets' growing economic clout and, to a lesser extent, greater political influence.

A second and probably more fundamental theme was the general agreement that countries around the world should refocus on balancing their sources of growth and thereby possibly mitigating the impact of future economic disruptions. Simply put, big importers such as U.S. should save more, while large exporters with high savings rates (such as Japan, Germany and China) should promote increased domestic demand to reduce dependence on exports for GDP growth. Such a unified global program has never been attempted and is unlikely to succeed. Since the underlying cause for many of these

imbalances is cultural, legislation is likely to do little to change that unless dramatic economic incentives are put in place.

Fiscal Stimulus and Austerity

The political will for further economic stimulus is ebbing globally. It is always hard to prove the effectiveness of such measures, although the consensus is that the trillions already spent have been the salve that brought the U.S., Western Europe and Asia back from the brink. In the U.K., though, Gordon Brown has exhorted developed nations to continue the stimulus and, in fact, implied that there was more ammunition left than had already been expended.

In contrast, austerity rather than expansionary fiscal policy has brought confidence back to Eastern Europe. Early in the financial crisis, investors feared the core Eastern European markets would not be able to honor their debts in the face of depreciating local currencies. Surprisingly, many of these markets have since generated among the strongest returns for U.S. dollar-based investors, as these countries sobered up from their decade-long debt binges by adopting fiscal discipline. In Hungary, for example, the budget deficit has declined from 9.2% of GDP in 2006 to just 3.4% in 2008, with more cuts instituted so far this year.

Changes in Japan

Finally, during the third quarter, Japan experienced what could become one of its greatest political shifts in the post-War period. With the Liberal Democratic Party (LDP) marginalized more than any time in the past 50 years, leadership is now in the hands of the more liberal Democratic Party of Japan (DPJ). An important difference in philosophy may now be tested, since the DPJ will likely promote stimulus focusing on the consumer, a sharp contrast to previous LDP actions supporting the corporate sector.

Commercial real estate must work through a big debt problem

Commercial real estate continued to decline in the third quarter. It over-indulged in cheap credit as did every other borrower in the last debt bubble. Total commercial real estate debt more than doubled from \$1.7 trillion in 2002 to \$3.5 trillion in 2008. This represented a rise from 16.5% of GDP (in the long-term normal range) to an excessively high 24.5%. Does this mean that we must expect a trillion dollars of mortgages to be written off as a result of the financial crisis and the recession? Not necessarily. We foresee a complex three-part path through this debt problem.

Three Steps to Solving the Debt Problem

First, there definitely will be write-offs, especially in the construction loan arena, where over 15% of loans are already in default. These write-offs are expected to force the closing of perhaps 200 more of the smaller banks, which typically are the lenders to local developers. There will also be write-offs of the lower-rated tranches of commercial mortgage-backed securities (CMBS).

Secondly, in order to spread out the impact of the problem—and thereby avoid another shock to the financial system—banks will likely roll over maturing loans into new loans as they come due, as long as the borrower can continue to cover the interest payments (and perhaps come up with some equity to reduce the loan). This is the so-called “pretend and extend” scenario that has become possible since the “mark to market” rules have been eased. (From the borrower’s point of view, this practice is known as “delay and pray.”) With regard to maturing CMBS debt, discussions continue about finding a way to either extend these loans or have the Fed step in to help.

Thirdly, we need a massive re-equitization of the commercial real estate market, and there are signs of hope. Institutional real estate funds still have reserves of potential buying power in unspent cash—the “money on the sidelines”. Furthermore, the NCREIF-Townsend Opportunistic Funds index revealed a \$6.5 billion infusion of new capital in the first quarter of 2009, right in the depths of the crash. (Second quarter data is not yet available.) Most of this new capital probably represented calls on prior investor commitments, but the fact that the calls were funded is encouraging. And, there was probably more

money raised that was not reported in the index. Last, and most importantly, publicly-traded REITs have been working to rebuild their capital base by raising \$18 billion of new equity in the first half of this year. This leadership by public REITs is reminiscent of their resurgence in the aftermath of the 1990’s Savings and Loan credit crisis.

Investor Psychology

The biggest problem currently is investor psychology. No one wants to invest too early and watch their investment get written down further. In the first quarter of this year, only nineteen properties were sold out of the NC-REIF Index. Even though this activity rose to 43 properties in the second quarter, it is still well below normal. Most quality properties are being held off the market awaiting better times. Once transaction activity picks back up, we expect much of the so-called “shark” (i.e. “bottom feeder”) money will rush to market in order to avoid being left behind. That should signal the bottom of this cycle. We just can’t foretell exactly when that will happen.

The biggest problem currently is investor psychology.

We have reduced our equity exposure to address portfolio drift

We are in a disciplined way reducing stock holdings on significant rallies in an effort to maintain a diversified balance among asset classes.

In July, we removed the drift in portfolios that occurred as the stock market surged from the March lows. We brought our portfolios back to our guidelines, which seek to balance high volatility and low volatility assets. Since then, stocks have moved higher and portfolios have once again drifted away from guidelines. We allowed this drift to continue until early October, when we once again scaled client portfolios back to guidelines.

U.S. Stocks: Underweight

The U.S. stock market appears to be discounting a sustainable recovery. As outlined in the economic section of this newsletter, we do not believe this outcome is a “slam dunk”. We see a number of risks that are causing us to tilt portfolios away from our long-term normal (i.e. strategic) position in stocks. With stocks now very overbought and fear turning into complacency, we are in a disciplined way reducing stock holdings on significant rallies in an effort to maintain a diversified balance among asset classes.

International Stocks: Neutral

Foreign markets have moved higher along with U.S. stocks. U.S.-based investors also benefited from weakness in the dollar. Until recently, we allowed the international exposure in client portfolios to drift higher. At the beginning of October, we removed this drift and returned to guidelines. Although we continue to see long-term opportunity in international stocks (particularly in the emerging markets), we believe these markets have advanced too far too fast.

Bonds: Underweight

The ten-year U.S. Treasury bond yield fell 25 basis points (0.25%) in the third quarter to 3.30% and prices rose modestly. Year to date, these yields have risen over 100 basis points (1.0%) and U.S. Treasury bond prices have fallen. We continue to see bonds as a recession hedge and an insurance policy against deflation. Given high and rising budget deficits, a falling dollar and the possibility of an end to the Fed’s quantitative easing, the risk in bonds is not trivial. As the economy pulls out of the recession, with excessive monetary growth, inflation expectations are likely to ramp higher and interest rates to increase. Although

this is not a problem yet, given today’s relatively low yields, we see little value in bonds. Our models suggest the fair value yield for the ten-year U.S. Treasury bond is around 4.5%.

Real Estate: Neutral*

Commercial real estate continues to suffer from a very difficult economic and financial environment. Rising capitalization rates and a challenging operating environment are putting pressure on property valuations. Unlike prior economic cycles, real estate has been more closely correlated with stock prices. As long as the economy remains weak, the environment for commercial real estate will likely remain challenging. However, with valuations improving, a significant buying opportunity may soon be at hand.

Alternative Investments*

We are constantly looking for ways to enhance returns and/or lower risks. Some alternative investments offer diversifying opportunities to offset risk inherent in equity 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.

U.S. INTEREST RATES	12/31/2008	3/31/2009	6/30/2009	9/30/2009
Cash Equivalents				
90-Day Treasury Bills	0.09%	0.21%	0.20%	0.12%
Federal Funds Target	0.25%	0.25%	0.25%	0.25%
Bank Prime Rate	3.25%	3.25%	3.25%	3.25%
Money Market Funds	2.29%	0.72%	0.29%	0.21%
Bonds				
30-Year U.S. Treasury	2.68%	3.54%	4.33%	4.05%
20-Year AA Municipal	5.21%	4.93%	4.84%	3.86%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 9/30/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 Year Treasury Index	2.70%	-3.72%	7.98%
Merrill Lynch 7-10 Year Agency Index	2.60%	0.56%	11.01%
Merrill Lynch 5-10 Year Corporate Index	9.23%	21.11%	21.02%
Barclay Capital Municipal Bond Index	7.12%	14.00%	14.85%
International Bonds			
Citigroup non-US\$ World Government Bond Index, fully hedged	2.03%	2.24%	7.87%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 9/30/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	15.79%	13.52%	-7.37%
S&P 500	15.59%	19.27%	-6.91%
NASDAQ 100	16.55%	42.66%	8.61%
S&P SmallCap 600/Citigroup Value	20.08%	17.63%	-11.20%
International Stocks			
MSCI Japan, net dividends	6.51%	9.27%	-0.57%
MSCI Europe (includes UK), net dividends	22.92%	31.56%	1.57%
MSCI EAFE (Europe, Australia, Far East), net dividends	19.47%	28.97%	3.23%

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

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 9/30/09	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-5.20%	-16.72%	-23.62%

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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