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A Quarterly Review of Economic and Market Developments

2ND QUARTER 2010

BAILARD INTERVIEW

Ask the Chief Economist

In this wide-ranging interview, Chief Economist and Investment Strategist Art Micheletti shares his views on everything from the outlook for the U.S. stock market to fiscal policy and the impact of higher taxes.

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Chief Economist and
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U.S. stocks fell sharply during the last quarter. Do you expect this decline to continue?

As of June 30th, it is unclear if what we are witnessing is merely a correction after a huge stock run-up or the start of another major downturn. Even if the decline is only a correction, it may have further to run. Historically, strong market up-moves of the type we had over the last year are typically followed by big declines. From the lows of the last year, stock prices as measured by the S&P 500 rose about 80% before peaking in April. This type of up-move is rare; the only comparable up-moves occurred during the 1930's. Both periods were followed by sharp declines of -35% to -50%. A general rule of thumb is that market corrections tend to retrace half of their run-up. A move of this magnitude would take stocks down another 10% to 15% from their March 31st levels. With the stock market making lower highs and lower lows, a clear downtrend is in place. We are inclined to wait for the stock market to stabilize, reestablish a new uptrend or for stocks to become significantly undervalued before adding back to this asset class.

Some commentators believe the U.S. is headed for another Great Depression unless the government

continued on page 2

IN THIS ISSUE

U.S. Economy 4
A slowing economy is expected to weaken further in the second half of this year.

International Economies 6
The trend toward slower growth overseas is likely to continue.

Fixed Income/Foreign Exchange 8
A flight to safety boosted both the dollar and U.S. Treasury bonds during the second quarter.

Domestic Equities 9
U.S. stocks experienced double-digit losses.

International Equities 10
International stocks also declined.

Real Estate 12
A comparison of the current commercial real estate crash to that of the early 1990's raises questions about how long the bottoming process will last this time around.

Bailard Investment Strategy 13
During the quarter, we made several moves to protect our portfolios from downside risks.

Market Performance 15

Ask the Chief Economist (continued)

continued from page 1

passes a new fiscal stimulus plan. What is your view on that?

I think it would be a big mistake. Throughout the economic decline, the government has tried to ease the pain with bailouts and fiscal stimulus. After trillions of dollars of deficit spending, there has been no net increase in private sector jobs.

The stimulus has provided temporary relief to certain sectors of the economy, such as autos and housing. However, this type of stimulus tends to pull demand forward and gives benefits to consumers that would have bought anyway. The benefits thus tend to be transitory, while the stimulus leaves behind a legacy of higher debt.

The current financial difficulties have been caused by decades of excessive debt creation, bloated budget deficits and politicians promising more than they reasonably could deliver. Doing more of the same seems like sending good money after bad. When the problem is debt, going more heavily into debt is not likely to be the solution.

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While more fiscal stimulus may not be ideal, won't the austerity plans in Europe work against growth as well?

Yes, but unfortunately, for many countries today the reality is that, without austerity budgets, tremendous sovereign default risks could be much worse for long-term economic prospects. Although these countries spent wildly to keep their economies above water, the underlying dynamics have not changed. There is too much debt. Japan tried to spend its way out of recession and now is saddled with a 200% debt-to-GDP ratio after two decades of slow growth.

So what can we do?

Stop doing what is not working. Given the current unprecedented level of debt in this country and overseas, taking on more debt is likely to only prolong and worsen the economic adjustment. It may provide temporary relief but will create more economic uncertainty and volatility. Unfortunately, this suggests the best remedy is to let the excesses work themselves out and accept lower levels of growth while the deleveraging process works through the economy. It takes time to recover from economic contractions triggered by excessive debt creation. The excesses took decades to build and will not be resolved by excessive spending.

Many tax rates are due to increase at the end of 2010. What impact will these higher taxes have?

At the end of this year, the U.S. will face the largest tax hike in its history if Congress fails to act to prevent the automatic expiration of the Bush Administration's 2003 tax cuts. Marginal income tax rates will go up, with the top marginal rate increasing from 35% to 39.6% (actually over 40% given the loss of deductions and exemptions for certain high income tax payers). The long-term capital gains tax rate will rise from 15% to 20% and possibly 25%. Dividends will be taxed as ordinary income (at up to 39.6%) rather than at the current 15% rate. The Alternative Minimum Tax will ensnare 28 million taxpayers, up four million from last year. Taxes for both small and large businesses will increase due to changes in the expense and depreciation rules. (Sub-S corporations will have their rates rise with the personal income tax rates.) The estate tax goes back to 55% from 0% this year and the exemption will be lowered. The marriage penalty will be restored, and the standard deduction will no longer be doubled for married couples relative to singles. Finally, the new healthcare plan will eventually impose new taxes on certain businesses and high income individuals.

When you raise taxes on something, you tend to get less of it, everything else being equal. Higher income taxes will likely lead to less income generation, while a higher tax on capital gains and dividends will probably mean less capital investment. This could undermine economic growth and job creation. In a struggling economy where

Ask the Chief Economist (continued)

you are trying to create jobs, higher taxes would likely do more harm than good.

Are there any potentially positive catalysts for the stock market?

Extending the Bush administration's tax cuts would be a nice surprise but is highly unlikely. If anything, political momentum is moving toward even higher taxes.

Corporate profits could continue to surprise on the upside. However, in an environment of weak nominal economic growth, revenue growth is likely to remain muted. Margins have already expanded as labor costs have fallen, and a further expansion in margins may be more difficult. In addition, expectations for earnings over the next year are already very optimistic.

Corporations have large cash balances which they could use to increase dividends, repurchase shares or increase merger and acquisition activity. Since top line growth is soft, some corporations may choose to grow by acquisition. The more uncertainty you can remove, the more eager corporations will be to put their cash to work.

With the Fed unlikely to raise rates anytime soon and interest rates at historically low levels, the competition for stocks from bonds has been reduced, making stocks relatively more attractive.

Similar to Japan during the 1990's, as the deleveraging process continues, equities are likely to trade sideways, with large market fluctuations creating opportunities along the way.

Dirt cheap valuations would also be a very positive catalyst for the stock market.

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The U.S. economy is slowing

If there is a surprise, it is likely to be on the downside.

First quarter 2010 GDP growth was revised down twice from the originally reported 3.2%, first to 3.0% and then to 2.7%. Although this was the third positive GDP quarter in a row, it represented a marked deceleration from fourth quarter 2009 growth of 5.6%. Second quarter 2010 growth is estimated at 2.5% annualized. If there is a surprise, it is likely to be on the downside.

Consumer Spending Is Sluggish

Consumer spending remains sluggish without government incentives for cars, appliances, etc. Real consumption slowed in the first two months of the second quarter to a 2.3% annualized growth rate. Consumer confidence has rolled as the employment outlook has failed to improve, housing appears to be double dipping and the financial markets remain under pressure. Government transfer payments are set to slow as Congress has thus far failed to extend unemployment benefits. Private sector income growth remains anemic, and income will also start to lose the benefit of census worker jobs over the next few months. The only real economic power resides with the consumer. Without underlying strength in income and employment, sustainable above trend growth is unlikely. The economy is not yet at the point where healthy sustainable consumer spending can underpin growth.

Housing Is Double Dipping

Housing activity is clearly double dipping, with starts, permits, home sales, builder sentiment, housing related stock prices and mortgage applications for purchase all heading lower. Pending home sales plunged -30% month-to-month in June, indicating weak new and existing home sales over the next few months. The home buyer credit which expired at the end of April clearly helped lift home sales, but only by bringing demand forward, leaving a potential demand void over the next few months.

Inventory rebuilding has been a source of strength for the economy over the last six months, contributing 3.8% to fourth quarter 2009 and 1.7% to first quarter 2010 economic growth, or about 65% of economic growth.

While shifts in inventory provide transitional strength to economic activity, inventory building is not a sustainable source of economic growth. Inventories appear to be at an appropriate level, but stronger factory sells and shipments may be required to increase them further.

Manufacturing, Exports and Government Spending Are Likely to Slow

The manufacturing boom may be beginning to fade. Factory orders fell -1.4% in May and shipments in April and May averaged -0.7%. With auto sales disappointing in June, a reduction in production may be in order. Most national and regional manufacturing composite indices, while still positive, appear to have peaked and are rolling over.

Export and import growth has been relatively strong, reflecting stronger overseas growth and better domestic growth. On balance, the trade situation has deteriorated with the trade deficit widening modestly. Going forward, given recent dollar strength, austerity plans in Europe and efforts to deflate China's property bubble, export growth is likely to slow.

Government spending has been a negative contributor to GDP over the last two quarters, as state and local cutbacks have more than offset federal stimulus. The impact of the $862 billion federal stimulus passed last year is starting to fade and providing less of a boost to GDP. Proposals to adopt a second stimulus plan face stiff resistance in Congress and from the American people, who are concerned that you can't borrow and spend your way to prosperity. The $100 billion plus Bush stimulus plan in 2008 and Obama's plan last year had no lasting impact on growth. Many argue that an increase in long-term growth requires permanent changes in the tax code and keeping the government sector from absorbing and redistributing too big a slice of the economic pie.

Given the above, it is clear that economic activity is slowing. The Conference Board Leading Economic Indicator (LEI) and the OECD LEI are rolling over, while the Economic Cycle Research Institute Weekly LEI and Consumer

The U.S. economy is slowing (continued)

Metric LEI have declined sharply. It is likely growth will continue to decelerate in the second half. Given that the largest tax hike in history is only six months away, the potential for falling back into recession remains relatively high.

Impact of Upcoming Tax Hikes

Perversely, the upcoming tax hikes could force economic activity into 2010 to get better tax treatment. This would free up income for a growth surge later in the year at the expense of growth in 2011.

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International economic growth is also slowing

European policymakers see austerity as a better choice than a sovereign debt implosion.

Europe

Eurozone GDP increased 0.2% quarter-to-quarter in the first quarter of 2010 and was up 0.6% year-over-year. Sluggish growth is likely to continue. Retail sales increased 0.2% in May after a -0.9% decline in April, putting the second quarter off to a slow start. Industrial production remained relatively healthy, as export demand continued to be strong. With growth in the U.S. and China slowing, this may change. European exporters have been benefitting from an extremely weak euro, which has recently rallied sharply. The ZEW Investor Expectations Survey, which historically has been a good leading indicator for Europe, fell to 18.8 in June from 37.6.

Fiscal excesses have created a huge sovereign debt problem, leading interest rates and sovereign risk spreads in many European countries to increase significantly and potentially undermine long-term growth. The Europeans, seeing how government spending has failed to ignite growth, are refusing to authorize additional spending. At this time, European policymakers see austerity as a better choice than a sovereign debt implosion. With austerity measures being put in place throughout Europe, it is likely that growth will remain anemic and Europe could slip back into recession.

United Kingdom

U.K. GDP increased 0.3% quarter-to-quarter in first quarter and -0.2% year-over-year. With the economy no longer in free fall, the new Cameron government passed an austerity plan to narrow the deficit and return to some semblance of fiscal responsibility. The U.K. believes that the threat of bond vigilantes going on a buyers' strike is a greater risk to the country's economic well-being than austerity measures. As a result, its newly elected policymakers are vowing to push through some tough reforms that would have been unthinkable a few years ago.

Over the next five years, the British government plans to cut borrowing from 10% of GDP to 1% of GDP. Impressively, George Osborne, the Chancellor of the Exchequer, has said that four-fifths of the fiscal retrenchment will come from public spending cuts and only one-fifth from taxes, which would be shared by everyone in the form of an increase in the Value Added Tax (VAT). Under the plan, the VAT will increase from 17.5% to 20% (essentials such as food, clothing and books will remain exempt). To avoid hitting the most needy, the income ceiling at which the lowest rate of income tax is levied would be raised. The capital gains tax would increase from 18% to 28%, but the corporate income tax would drop from 28% to 22% over four years. While the increase in the capital gains tax works against capital formation, the cut in corporate income taxes to one of the lowest rates in the world should more than offset this drag.

On the spending side, public worker pay would be frozen and housing benefits would be reduced. The state pension retirement age would increase from 65 to 66, and might go to 67. Welfare benefits would be indexed to the more conservative Consumer Price Index rather than the Retail Price Index. Finally, the majority of government departments would face budget cuts of 25% (unthinkable in the U.S.). The plan, if implemented, should help restore fiscal order without compromising growth too much.

Asia

In Asia, growth has been driven by exports, with the region benefitting from China's on-going expansion. However, China is now hitting the policy brakes to contain inflation expectations and an overheating real estate market. As a result, growth in Asia is likely to slow. In fact, with the U.S. slowing and Europe introducing austerity packages, one risk is that China could be the tipping point for turning the global economy back to recession. Although the government is trying to improve domestic consumption, Chinese growth is still very heavily dependent on exports. Weaker U.S. and European demand may lead to slower Chinese export growth. The modest revaluation in the renminbi is unlikely to have a significant impact; however, on the margin, a stronger currency hurts exporters but helps importers. China's LEI and Purchasing Managers Index are showing signs of rolling over, confirming this slower growth outlook. Economic uncertainty is being reflected in Chinese stock prices, which have

International economic growth is also slowing (continued)

fallen about -30% (as measured by the Shanghai Composite) from last fall through the end of the first quarter.

Japan

Japan's GDP increased a better than expected 1.3% quarter-to-quarter in the first quarter of 2010, bringing year-to-year growth up to a positive 1.6%. Since then, growth appears to be fading. Retail sales in April and May were down a cumulative -1.5%, and year-over-year growth slowed from 4.9% to 2.8%. The industrial sector shows shipments falling sharply while production has been flat. The net result is that inventories are starting to build, which will likely slow production going forward. Japan's monetary base shrank in June, and bank lending and broader money growth remain anemic. Exports slipped 1.2% in May due to fewer shipments to the U.S., Europe and China. The Composite Leading Index fell -2.9 points in May after declining -0.2 points in April. The Diffusion Index of LEI components fell to 55% positive from 90.9% in April. Japanese stocks are also confirming the slow growth outlook by sinking lower. On a positive note, the Manufacturers Tankan Survey improved sharply in second quarter to +1 from -14.

Japanese growth appears to be fading.

U.S. bonds and the dollar had a good quarter

Investors increasingly viewed U.S. Treasuries as a safe haven.

FIXED INCOME

The U.S. bond market enjoyed good returns during the second quarter, with the broad-based Merrill Lynch U.S. Corporate, Government and Mortgage index gaining 3.5% for the three-month period. Ironically, despite record-breaking federal deficits, the best performance came from U.S. Treasury issues. In a world roiled by the European sovereign debt crisis and concerns about the sustainability of the economic recovery, investors increasingly viewed U.S. Treasuries as a safe haven. As a result, long-term government bonds enjoyed their second best quarter in more than 20 years. The yield on 30-year U.S. Treasury bonds fell from 4.7% on March 31st to 3.9% on June 30, producing a 15.3% return for the quarter. According to the Merrill Lynch Master Treasury index, Treasury issues of all maturities returned 4.7%. outpacing all other forms of debt. High yield debt fared the worst, as credit spreads widened in concert with equity weakness.

From a global perspective, U.S. bond returns stood up quite well. Europe, unsurprisingly, fared worst among the global bond markets. Even excluding those markets caught up in the storm of European debt crisis, U.S. Government debt outperformed all of the major markets with the exception of Denmark.

Municipal Bonds

The fiscal picture for municipalities and states within the U.S. has worsened due to a combination of shrinking property tax revenue and reduced stimulus funds from the federal government. Moreover, it has become increasingly apparent that government support for the Build America Bond program, which assisted municipal bond issuers with interest payments, will decline over the next few years. This will have the impact of returning more of the fiscal burden to the issuers.

FOREIGN EXCHANGE

The European sovereign debt crisis continued to dominate the global currency markets in the second quarter. With global anxiety high, currency investors flocked to the perceived safety of the U.S. dollar and the Japanese yen.

The dollar rose against all major currencies except the yen. The Japanese currency advanced a further 5.7% versus the dollar during the quarter, approaching an all-time high. Other currencies' performance versus the greenback was less impressive. The euro declined -9.4%, the Swiss franc lost -2.2%, and even the high-flying commodity currencies of Australia and Canada failed to match the dollar's strength, falling -8.3% and -4.6%, respectively.

A dichotomy is beginning to emerge in global monetary policy. Some emerging markets, increasingly concerned about inflation, have begun to raise short-term rates. However, neither the U.S. nor Europe have indicated any near-term intent to do so.

Looking forward, the prospect of relatively higher interest rates and growth rates in the emerging markets suggests that a resurgence in the strength of these currencies relative to the dollar may be expected. This will be more likely to come to pass if continued progress on resolving the European sovereign debt crisis reduces the "safe haven" demand for the U.S. dollar.

U.S. stocks fell during the second quarter

The second quarter was a tough one for the U.S. equity markets generally. The S&P 500 index fell -11.4% for the three months, putting it in negative territory year-to-date, but still up 14.4% over the twelve months ended June 30, 2010. The NASDAQ 100 dropped -11.0% for the quarter, making its return negative year-to-date, but up 18.5% over the trailing twelve months. Small value stocks, as measured by the S&P/Barra 600 SmallCap Value Index, fared best, slipping -10.4% for the quarter and down slightly year-to-date, but still up 23.6% over the trailing twelve-month period.

Fears of a double-dip recession domestically, and numerous government debt crises internationally, have provided some investors with sufficient incentive to stay away from stocks for the time being. As of this writing, domestic equities are currently hovering close to fair value based upon trailing five-year normalized earnings, so a bargain hunters' rally seems unlikely in the near term. Investor sentiment dipped briefly during the quarter, but remains largely complacent, depriving the market of potential fuel for a rally from this quarter.

Longer Term Outlook

So where does that leave us? It is almost impossible to predict the U.S. stock market's return in the short term. Longer term, we should remember that 2008's huge losses and 2009's massive rally have been the exception, not the rule when it comes to stock market returns. Large cap stocks average about a 10% annual return over the long run, with small cap stocks doing a bit better, at around 12% per year. These are still the best long-term return games in town when compared to the alternatives like bonds or cash. The recent past may have us forgetting that, two-thirds of the time, stock returns have historically been between 26% and -6% per year.[1]

Possible Catalysts for Improvement

Positive second quarter earnings surprises, an improving economic outlook or a more business-friendly political climate could each result in improving stock market fundamentals and greater investor interest in equities. As always, the timing of any of these events is uncertain, and when the market moves, it often moves quickly. In the long run, the path to positive after-tax and inflation returns leads though the stock market, so while current market prospects do not appear particularly exciting, there is a lot of truth in the old saying that, "slow and steady wins the race."

In the long run, the path to positive after-tax and inflation returns leads through the stock market.

1 Sources: Ibbotson Associates and Bailard Research. Stock returns are based on market index data from the last 1920's through 2009. Stocks can lose money. **Past performance is no indication of future results.**

International stocks were hurt by a strong dollar

The European sovereign debt crisis continued to dominate the international equity markets in the second quarter.

During the second quarter, international stocks experienced double-digit losses. Developed country markets, as measured by the MSCI EAFE index (net dividends, U.S. $) lost -14.2%, while the broader based MSCI All-Country World ex-U.S. index (net dividends, U.S. $) fell -12.4%. Most of this decline occurred during the May sell-off, a period marked by a declining U.S. stock market and swirling uncertainty over policymakers' response to the European sovereign debt crisis. A strong U.S. dollar (which rose 7.4% versus the euro in May) also hurt international equity returns for U.S.-based investors. For the quarter as a whole, the top-performing region was emerging Asia, whose MSCI index declined just -5.2% in U.S. dollar terms. Europe and developed Asia, on the other hand, were among the weakest markets.

European Sovereign Debt Crisis

The European sovereign debt crisis continued to dominate the international equity markets in the second quarter. Its impact could be seen in rising bond yields, increased illiquidity within the European money markets and a dramatic sell-off in both European stocks and the euro.

Short-term efforts to address these issues have only recently gained some traction. Global investors were unimpressed with the European Finance Ministers' May 10th announcement of a 750 billion euro bailout program. However, the European stock market responded more favorably to a mid-June agreement to adopt a European Commission proposal to deal with the problem of widely varying fiscal policies within a single currency bloc. The agreement seeks to improve fiscal discipline through budgetary oversight by creating a system of peer reviews of yearly national spending plans beginning in 2011.

Emerging Policy Dispute

Toronto's G-20 Summit at the end of June revealed a growing division between U.S. and European policymakers over the role of further economic stimulus to resolve the global growth crisis. Europe, suffering acutely from the perceived risks of an over-dependence on sovereign debt, is prepared to scale back fiscal stimulus in order to restore credibility to the region. The U.S., although it has taken on a large amount of Treasury debt, is doing so at historically cheap rates. Since global investors aren't penalizing the U.S. for its high levels of sovereign debt, the Obama administration is much more biased toward further fiscal stimulus to support the nascent recovery.

So long as concerns over Europe's willingness and ability to pay its sovereign debt commitments remain, there is little prospect for euro strength. Germany has the most to gain from euro weakness, as it is also the European nation most leveraged to global demand due to its increasing dependence on exports. Since German unification, exports as a percent of GDP have risen from below 30% to more than 40% today. The influx of cheap labor over the past 20 years and tight controls on wage gains have increased German export competitiveness, but at the same time left the citizenry with less disposable income. That lower disposable income is another factor pushing the balance of Germany's GDP towards exports and away from domestic demand.

Developments in Asia

Investors are looking to the Far East (particularly to China) to assess the strength and sustainability of the global recovery. Is an overheating China facing higher inflation and slower growth prospects? Inflation is clearly a concern for policymakers. China has increased its bank reserve requirements three times this year to restrain loan growth. Moreover, its decision to allow its currency (the renminbi) to rise appears in part to have been motivated by a desire to curtail inflation. But, so far, inflation appears limited to the real estate sector of China's economy. Chinese economic growth is likely to slow without the support of the massive fiscal stimulus of 2008 and 2009. As noted earlier in the newsletter, Chinese exports may also be adversely affected by declining Western demand and a rising renminbi. But, even with the slowdown in growth, China's GDP will likely increase over 10% this year. Slower than expected growth would have negative implications for the global recovery and for the international stock markets.

International stocks were hurt by a strong dollar (continued)

Reasonable Valuations

The tumult of the past several years, while leaving investors a bit bloodied, hasn't resulted in particularly cheap international stock valuations. Globally, valuation levels, measured against earnings, are generally in line with long-term history. Thus far in the recovery, most earnings improvement has come from cost-cutting; the more valuable form of earnings expansion, and that which merits higher multiples, is due to growing revenues.

Valuation levels, measured against earnings, are generally in line with long-term history.

Real estate might take longer to bottom

It may take perhaps a year or two for the really good investment opportunities to appear in larger numbers.

Many investors are looking back to the 1990 to 1993 commercial real estate correction for clues about the possible future of the current commercial real estate market crash. However, they should be aware of three very important differences between the two downturns:

1. **Different causation.** The 1990 crash was caused by an inflation-induced over-building boom, which resulted in catastrophic vacancy problems. The current downturn was caused more by the bursting of a debt-induced asset bubble, although the resulting impact on the economy has also led to deterioration in occupancies across the asset class.

2. **Different appraisal response times.** The 1990 crash actually began in the late 1980's, but the industry's reluctance to mark down assets delayed the recognition of it until a few years later, when the players could no longer remain in denial. Determined to not repeat that mistake, this time around institutional managers started marking down assets right away, even though there might at times have been scant evidence of such pricing in the marketplace.

3. **Different availability of opportunities for opportunistic buyers.** The loan problem before was concentrated in the savings and loan industry, one which could be sacrificed without jeopardizing the whole economy. The closing of the savings and loan industry resulted in a tremendous quantity of cheap opportunities available through the government sponsored Resolution Trust Corporation as well as from other financially distressed sellers. This time around, the problem with the bad loans runs the risk of overwhelming the banking system, which the government cannot afford to let fail in the aggregate. Hence, the government has adopted rules which allow banks to not write down underwater commercial loans so long as there is some ability to "pretend and extend" any loans currently coming due.

The implication for investors is that this market bottom might be more drawn out than the last time around. Already some high-return "shark" funds have returned investor money for lack of investing opportunities. The length of the bottoming process could be drawn out for two reasons: 1) the slowness of the economy to rebound from such a broad-based financial crisis; and 2) the slowness with which banks and other lenders may clear the bad loans off their balance sheets.

While investment property transaction volumes have rebounded (double that of last year this time), they remain well below normal levels. More importantly, they are still concentrated in top-tier core properties (fully occupied properties in the top ten metro areas of the U.S.). Core real estate funds with money to invest are having to pay price multiples close to those that existed at the top of the bubble for such properties. Properties in secondary markets, or properties with some vacancy problems, are still slow to come to market. There is not yet enough financial distress to force lenders to foreclose or for sellers to dump assets. Even though banks are gradually selling off their assets and their loans as they work to rebuild their balance sheets, they are obviously selling the best properties first. It may take perhaps a year or two for the really good investment opportunities to appear in larger numbers.

Need for Patience

So we believe patience is called for, on the part of buyers. Our concern is that those buyers currently paying top dollar for "trophy" core properties may be making a big mistake if the economy takes a double-dip, or merely takes longer to rebound. If today's fully occupied trophy buildings start to experience some vacancy on future tenant turnover, such high-multiple properties will have to be marked down to the depressed levels of all other assets, giving the investors a real loss on their investment. Conversely, if one paid less for a property with vacancy problems—and the vacancies take longer to fill—at least the price won't have to be written down so drastically. Of course, market bottoms are notoriously difficult to call, and only become obvious after the fact. To catch the best opportunities, investors need to be ready to buy at any time. Meanwhile, we will keep our fingers on the pulse of the market, and keep you posted of future changes.

We added to bonds and gold in May

During the quarter, we made a number of tactical shifts in our asset allocation strategy. In early May, we removed portfolio drift from some of our equity positions. Later in May, as stock prices drifted lower, we added to our bond position and to gold to provide additional downside protection to our portfolios. Softer economic news, concerns about sovereign debt risk, the BP oil spill, uncertainty surrounding financial reform legislation and geopolitical tensions between Israel and Iran, and North and South Korea increased our concern about portfolio risk.

U.S. Stocks: Underweight

U.S. stocks declined sharply during the quarter, falling -11.4% on the S&P 500. With the S&P 500 still in a down trend, we want to be careful in adding back to the equity markets, particularly since the downturn may not yet have run its course. Equity valuations are within the fair value band. If the S&P 500 fell to 900, stocks would be more interesting from a value perspective. The longer term structural problems with debt, residential mortgage resets, commercial real estate rollovers, maturing debt rollovers and weakening economic activity still put us in the cautious camp regarding the economic outlook. Our view is that, while there is considerable risk to that outlook, stocks are starting to discount a less robust future. If the market were to pull back to extremely undervalued territory, we could begin adding back to our stock allocation.

International Stocks: Underweight

One by one, the global equity markets have been rolling over, starting with China in March and then spreading to Europe in May as sovereign debt risk hit both the euro and the stock markets. Emerging markets, which were less scathed by the financial crisis and possess better long-term growth prospects, have held up relatively well. We still see long-term opportunity in international stocks (particularly the emerging markets) but are concerned they will be pulled down by continued global economic weakness in the shorter term.

Bonds: Less Underweight

As mentioned earlier, we added to our bond portfolios in late May as a defensive portfolio measure. While there is little long-term value in bonds in the current historically low interest rate environment, we felt there was a tactical opportunity given weaker economic activity and the increase in safe haven flows.

With bond yields continuing to trend lower, we believed we could invest some cash and reposition our portfolios in a more defensive posture. The ten-year Treasury bond yield started the quarter at about 3.9% and ended the quarter below 3%. While yields are low, they could go lower. The cyclical low in the U.S. was 2.2%, reached in January 2009. In addition, Japanese bond yields have been trading around 1.5% over the last ten years. So yields could go lower and stay low for an extended period of time.

Longer term, we remain worried about the level of debt creation by the U.S. government and the risk this poses for potentially higher rates. However, the safe haven allure of U.S. debt is a bigger factor in the short term.

Real Estate: Neutral*

The commercial real estate market has begun to stabilize, with property demand by publicly traded REIT's and foreign investors pushing core property values higher. Institutional investors are still in a disposition mode. Valuations have improved; cap rates now range from 8.60% on industrial properties to 6.75% for apartments. Improved valuations and market stabilization make it tempting to move more heavily into the market, but commercial real estate is still facing a very difficult economic and financial environment. Rents are continuing to fall and vacancies to rise. Given our economic outlook, we don't expect a rapid turnaround in employment, which would be a key trigger for moving more heavily into real estate. Financing also continues to be a problem for the market. While the worst appears to be over, we are being patient before topping up portfolios.

During the quarter, we made a number of tactical shifts in our asset allocation strategy.

Alternative Assets*

We are constantly looking for ways to enhance returns and/or lower risk in portfolios. Some alternative strategies offer diversifying opportunities to offset risk inherent in equity portfolios. Other strategies that we employ 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	9/30/2009	12/31/2009	3/31/2010	6/30/2010
Cash Equivalents				
90-Day Treasury Bills	0.12%	0.06%	0.16%	0.18%
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	0.21%	0.06%	0.01%	0.09%
Bonds				
30-Year U.S. Treasury	4.05%	4.64%	4.72%	3.89%
20-Year AA Municipal	3.86%	4.11%	4.14%	3.95%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 6/30/10	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 Year Treasury Index	7.66%	9.31%	9.76%
Merrill Lynch 7-10 Year Agency Index	6.16%	8.21%	10.31%
Merrill Lynch 5-10 Year Corporate Index	3.45%	7.00%	19.00%
Barclay Capital Municipal Bond Index	2.03%	3.31%	9.61%
International Bonds			
Citigroup non-US$ World Government Bond Index, fully hedged	1.56%	2.69%	4.92%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 6/30/10	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-9.34%	-4.98%	18.93%
S&P 500	-11.41%	-6.64%	14.43%
NASDAQ 100	-11.01%	-6.17%	18.53%
S&P/Barra 600 SmallCap Value	-10.39%	-1.48%	23.55%
International Stocks			
MSCI Japan, net dividends	-10.07%	-2.71%	0.76%
MSCI Europe (includes UK), net dividends	-15.19%	-16.72%	5.70%
MSCI EAFE (Europe, Australia, Far East), net dividends	-13.97%	-13.23%	5.92%

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

REAL ESTATE TOTAL RETURNS (US$) THROUGH 6/30/10	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	0.76%	1.53%	-3.92%

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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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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