

BAILARD INTERVIEW

Countries Matter

Executive Vice President International Equity Research Eric Leve explains why Bailard believes you should focus on countries first when investing in international stocks.



Eric P. Leve, CFA
Executive Vice President
International Equity
Research

Your team has been focused on international investing for over fifteen years. Are there any “truths” for the long run that you’ve observed?

Put simply, “Countries matter”. Although many international equity managers focus first on selecting individual securities or sectors (as they do when investing in U.S. stocks), we see the most critical investment decision as knowing what countries to emphasize in your portfolio.

Is this “top down” focus on country selection unique?

No, but in recent years, many international equity portfolio managers have greatly decreased their reliance on country allocation as a means to add value, instead choosing to focus on sectors or securities.

What has driven this trend?

The short answer is changing perceptions about the international equity “opportunity set”. More than a decade ago, as the European Monetary Union was moving towards a single currency, many academic studies began to show that dispersions among the returns of the stock markets of different countries were declining. Everything else being equal, a smaller range of returns will decrease the opportunity to add value via country

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allocation decisions like overweighting those countries you expect to perform the best and underweighting those countries you expect to perform the worst. More recently, the global downturn of the past two and one-half years has reinforced the perception that international diversification has failed and that all markets are moving up and down in unison.

Is this perception correct?

No. Even though there may be some decrease in dispersion, the range of returns is still dramatic. According to MSCI data, country dispersion has been about twice that of sector dispersion over the fifteen years ended March 31, 2010. Some examples from last year help illustrate how profound this dispersion can be. In 2009, Finland returned just 11.1% in U.S. dollar terms while its neighbor Norway skyrocketed 87.1%. Among the markets of Eastern Europe, Hungary (the first nation to seek aid from the International Monetary Fund during this financial crisis and one of the most heavily indebted nations in the region) returned 77.6%, while Poland (one of the few nations in the world not to fall into recession in 2009) returned a more modest 41.5%. The first quarter of this year has also exhibited some interesting dispersion. China, the global growth leader, has lost -1.6% while Thailand, in the midst of political turmoil, has increased 13.2%. These are but a few examples of why we believe country allocation is a richer and more consistently producing vein to mine than others in the international arena.¹

Of equal importance to the size of this opportunity is the power of the tools to exploit it. Here, our testing and experience have shown that, even with good dispersion among sectors, forecasting relative future performance is very difficult. Strategies that employ this tool often add more risk than return to their portfolios.

Are there tools which you find critical in exploiting your country-first perspective?

There are at least two. First, the intrinsic and more subtle characteristics of countries, such as cultural, political and social differences among nations (especially in the emerging markets) are a critical component to understanding them from an investment perspective. Second, we believe that the dominant factors in selecting countries change over time but can be gleaned from observation of the broader investing environment. At times the most important driver of selecting countries is their recent performance, while at other times, relative valuations or the intrinsic risks of each country are most informative.

Speaking of risks, do the political, social and economic risks of emerging countries make them less desirable than developed countries?

Actually, an understanding of these risks is critical to a manager focusing on country allocation. Using tools that incorporate this information into a more traditional investment process can greatly enhance one's ability to select among these markets. In many cases, the improvements that emerging markets have achieved in these areas over the past decade have made them some of the most desirable markets globally, despite the fact that they are still riskier than more developed markets.

Does your emphasis on country allocation mean that you don't believe security selection is important?

Not at all. However, we see it as being secondary to the country decision. In fact, we have found over time that incorporating both a country perspective and a security-level one can smooth returns as these two potential sources of added value work very differently.

A good example of this is the past two and one-half years. During this period, quantitative managers who focused on selecting stocks found that many others employed similar techniques and what failed for one failed for all. This was es-

¹ Country returns are based on their respective MSCI country indices (net dividends) in U.S. \$ terms.

We believe country allocation is a richer and more consistently producing vein to mine.

Countries matter (continued)

pecially true during the market's upturn during the second and third quarters of 2009. In what many described as a junk rally, very cheap, low-priced and risky stocks tended to outperform those that would generally be recommended by a disciplined quantitative investment process. Many managers who utilized stock selection only experienced a dramatic turnaround from success over most of the last decade to very poor results through the "quant storm". Our focus on countries first (with a smaller emphasis on individual stocks) meant that, instead of historical success turning into recent failure, recent results fell to the middle of the pack, leaving us with respectable relative short-term results and continued excellence over longer time periods.²

Incorporating both a country perspective and a security-level one can smooth returns.

² **Past performance is no indication of future results.** Performance was negative during portions of this time period. In addition to market risk and the risk of loss, the risks of investing in international stocks include fluctuations in currency exchange rates, differences in accounting standards, less publicly available information and the risks of expropriation or nationalization. Emerging markets are riskier than developed markets. There can be no guarantee that Bailard's international stock strategy will achieve its investment objectives.

The U.S. economy is exhibiting signs of sluggish recovery

The key number to watch will be job growth in the private sector.

The U.S. economy is exhibiting signs of sluggish recovery. We expect the economy to continue to move forward at a modest pace, although the risk of a double-dip recession is likely to rise as the year progresses. So far, most of the recovery has been artificially induced and driven by inventory accumulation. Fourth quarter growth was up a strong 5.6%, with two-thirds of the increase coming from inventories. Final domestic sales (which remove the impact of inventory changes and exports) were up only 1.4%. While inventory building is useful in the short run, it is unsustainable without higher final demand or consumption.

Personal consumption has been a little higher in the last few months and will likely contribute 2% to first quarter GDP growth. However, the consumer has only three sources of spending power: income, debt or dissaving. On all three counts, the consumer does not have much spending firepower. A weak labor market and negative real wage growth are restraining income growth. Most of the increase in income that has occurred has been due to government transfer payments for unemployment benefits, welfare and one-time tax cuts. Over the last year, government transfers are up 12.3% while nominal income is up only 2%. The consumer is deleveraging and trying to reduce rather than take on more debt. The weak housing market has reduced collateral values to back new debt, and banks are reluctant to lend. So, the consumer has been augmenting consumption by reducing the savings rate from above 5% to 3.1%. To rebuild balance sheets, the consumer needs to save more.

Employment Numbers Improve

Non-farm payroll numbers were encouraging in March, rising 162,000 and much improved from a year ago. While good news, there is less here than meets the eye. Of the jobs created, 48,000 were for the census. These jobs, while paying well (\$22 per hour), are temporary, part-time positions, averaging 19 hours per week. In the last two census periods, about 500,000 workers were hired. The Census Bureau has indicated

that over one million workers will be hired for the current census. This suggests that job growth will be significantly higher in April, May and June. However, if history repeats itself, the census jobs will disappear by September.

Private Sector Job Growth and Unemployment Are More Problematic

The key number to watch over the next few months will be job growth in the private sector. On the surface, the private sector added 114,000 jobs in March. However, part-time jobs rose 263,000, which suggests on balance that more full-time jobs were lost and replaced with part-time jobs. In addition, the number of unemployed increased by 134,000 to 15 million and the unemployment rate was unchanged at 9.7%. The underemployment rate, which adds those working part-time for economic reasons and discouraged workers that have left the labor force to the number of unemployed, increased to 16.9% in March.

The unemployment rate will likely be sticky on the way down. In order for the unemployment rate to decline, the economy will have to add more than the 150,000 jobs per month required to absorb the monthly growth in the labor force. In reality, job growth will have to be even higher to absorb the pool of underutilized labor as discouraged workers rejoin the labor force. Census hiring should continue to distort payroll numbers and help support consumption in the first half of 2010. In the second half, however, overall job losses could accelerate and the unemployment rate could again begin to rise.

Growth has been supported by the massive \$860 billion stimulus program, the “cash for clunkers” program, the home buyer’s tax credit and the recycling of TARP funds. In the second half of this year, government stimulus will have reached its peak and will begin to slow, which should contribute to renewed economic weakness. Moreover, we are unlikely to see much stimulus from the states as they are facing serious budget difficulties.

The U.S. economy is exhibiting signs of sluggish recovery (continued)

Housing Still Under Pressure

Housing remains under pressure, with a huge visible and shadow inventory of homes still unsold. The shadow inventory includes homes that have been taken off the market by sellers waiting for better market conditions and homes sitting on bank balance sheets waiting to be sold. The pressure on the housing sector is unlikely to ease. Delinquencies and foreclosures are high and rising, while a new wave of refinancing is about to hit the market. In addition, the decline in commercial real estate construction is unlikely to turn anytime soon given rising vacancies and falling rents.

Other Obstacles to Growth

The economy may face a couple of more hurdles in the short term. Oil prices have moved significantly higher on hopes of economic recovery and increasing tensions in the Middle East. At the time of this writing, oil prices exceeded \$85 per barrel. If the economy continues to show signs of recovery, we believe oil prices could easily reach \$100 per barrel over the next six months. This is the last thing that consumers or businesses need at this time. Although the financial crisis has been given most of the credit for the Great Recession, the run-up in oil prices to \$150 per barrel in 2008 was a co-conspirator.

Rising interest rates with or without tightening by the Fed are also a risk. Over the last year, interest rates have been kept low by the Fed aggressively printing money. The massive expansion of the Fed's balance sheet was accomplished by purchasing Treasury, Agency and mortgage-backed securities. In total, the Fed purchased \$1.5 trillion in marketable securities. Given limited buying by domestic savers and reduced buying by foreigners, the Fed was the buyer of last resort. Looking forward, the federal budget has a projected deficit of almost \$1.6 trillion this year and the Congressional Budget Office has revised its deficit forecasts from \$700 billion per year over the next ten years to \$1 trillion per year. It is hard to see where the demand for this

debt will originate. The Fed, after supporting a stock bubble in the late 1990's and then a much greater one in real estate in this decade, has now facilitated perhaps the biggest bubble of them all – a bubble in government debt. Without the Fed as an accomplice, interest rates could rise sharply. The yield on ten-year U.S. Treasury bonds has risen to nearly 4% from 2.75% a year ago. As interest rates rise, mortgage rates should also increase.

Impact of Expiring Tax Cuts

There is one force that could add to growth in the second half – the automatic expiration of the Bush tax cuts at the end of 2010. This scheduled “de facto” increase in dividend, capital gain and ordinary income taxes could lead to a front loading of income and economic activity to this year to avoid higher taxes next year. It could also mean less growth later on.

Rising government involvement in the economy is creating numerous cross currents that are making economic forecasting (an already difficult proposition) even more challenging. However, increased uncertainty and the government's increasing share of the economy could be a drag against future growth.

Rising interest rates are also a risk.

A weak European recovery has been hurt by concerns about high debt levels

Europe

Eurozone GDP increased 0.1% in the fourth quarter of 2009, down -2.1% year over year. Since then economic data has been mixed. Industrial production increased a better than expected 1.7% in January and 1.4% year over year. However, new orders fell -2% in January, up 9.8% from the depressed levels of a year ago (but still down -28% from the peak). The Purchasing Managers Index for Manufacturing increased from 53.6 to 56.6 in March and well above the 50 level that indicates expansion.

The German ZEW Investor Survey fell to a worse than expected 37.9 in March from 40.2 in February, and the German IFO Business Climate Index slipped to 95.2 in February from 95.8 in January. The Eurozone Economic Confidence Index, a measure of executive and consumer sentiment, slipped for the first time in eleven months to 95.9. Confidence in Europe is being impacted by Greece's political and economic difficulties.

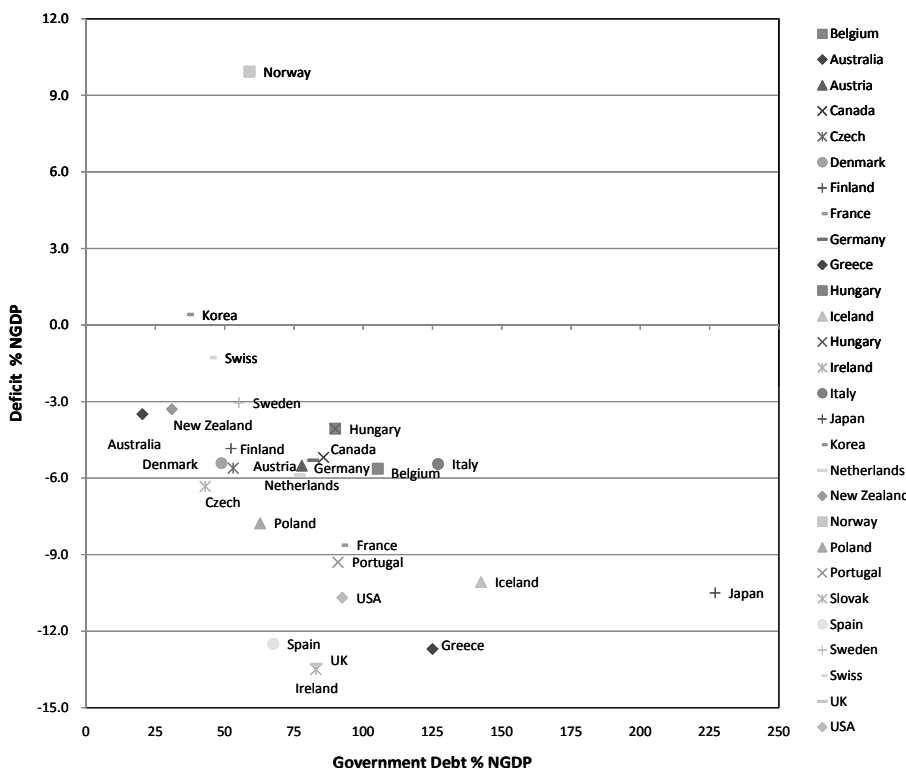
Economic deterioration has pushed the Greek budget deficit above 13% of GDP and total government debt outstanding to 130% of GDP. As a result, Greek bond yields have risen and credit default swap yields have widened. Default would have implications for all of Europe, as the contagion could spread quickly to the rest of the PIIGS countries

(Portugal, Ireland, Italy, Greece and Spain) and into Western European banks. Greece has adopted an austerity package to bring the debt and deficit down. However, it will be difficult to achieve the 60% debt to GDP and 3% deficit to GDP criteria originally required to join the European Monetary Union.

As can be seen in the chart below, Greece is not alone. Debt and deficits are a global problem. Extensive academic research indicates that when total government spending exceeds 25% of GDP and the ratio of debt to GDP exceeds 90%, structural economic growth slows significantly. As countries start to implement austerity measures, growth is likely to slow well below trend.

Debt and deficits are a global problem.

GLOBAL DEBT AND DEFICITS 2010 PROJECTION



Source: OECD Economic Outlook 86 database

A weak European recovery has been hurt by concerns about high debt levels (continued)

Japan

Japan's GDP rose a disappointing 0.2% in the fourth quarter of 2009, bringing the year-to-year decline to -3.3%. The results since then have been mixed. The Leading Index points to stronger growth ahead and the Large Manufacturers Tankan Survey improved from -24 to -14 in the first quarter. The trade surplus is also increasing, as Japan benefits from strong Asian demand. Domestic demand continues to look soft, however, with household spending falling a much worse than expected -1.7% in February and -4.3% over the last three months. Employment trends also remain anemic. Despite a zero interest rate policy, bank lending is still negative and the economy continues to deflate. Both the headline and core CPI numbers are in negative territory. Recently, Japanese stocks have been moving higher, which suggest that the outlook for corporate profits may be improving.

China

China's fourth quarter growth ramped up to 10.7% year over year. The first quarter of 2010 also seems to be off to a good start, with retail sales and industrial production heading higher. The Purchasing Managers Index rebounded in March to 55.8 after falling to 52 in February. China's exports also grew by a greater than expected 45.7% year over year in February, while imports increased a higher than expected 44.7%. However, the Peoples Bank of China is tightening monetary policy to slow growth. The central bank is worried that surging monetary growth and bank lending will lead to an overheating economy and exacerbate the bubble in real estate. The recent pull-back in the stock market and stalling in the leading economic index suggest monetary tightening may finally be working.

The biggest concern for China and global trade is protectionist pressure. The United States Senate is considering a bill that would apply stiff penalties to China if it does not revalue its currency. The bill is a rare act of bipartisanship introduced by Senators Schumer (D-NY) and Graham (R-SC). These strange bedfellows have

previously introduced legislation threatening to levy a 27.5% tariff on China unless it raised the value of its currency. The new bill would instruct the Obama administration to take action against China unless it allows its currency to float freely. In addition, 130 House members have sent a letter to the Treasury and Commerce Departments advising them to impose countervailing duties against countries that manipulate their currency.

Protectionism can be a very dangerous weapon to wield. The Smoot-Hawley Tariff Act of 1930 raised U.S. tariffs on over 20,000 imported goods. This led to retaliatory tariffs by U.S. trading partners, reducing American exports and imports by more than half and contributing to the severity of the Great Depression.

The biggest concern for China and global trade is protectionist pressure.

Bonds posted modest gains in the first quarter

FIXED INCOME

During the first quarter, bonds provided steady, if unspectacular returns. The broad-based Merrill Lynch U.S. Corporate, Government and Mortgage index returned 1.7% for the period. At worst, most sectors “made their coupons” but offered little else as interest rates were largely unchanged for the period. The only exceptions were corporate bonds. According to their respective Merrill Lynch Master indices, investment grade debt returned 2.8% and high yield debt returned 4.9%.

At the end of the first quarter, the difference between short-term yields (which are still close to zero) and the 30-year Treasury’s 4.75% yield was near all-time highs. Usually such a “steep” yield curve would be seen as an indicator of future growth. In this case, it is not so clear. Higher yields at longer maturities may also be a reflection of, among other things, credit risk. It is unheard of to speak of U.S. Treasury debt in this way, but along with much of Western Europe, we are reaching debt-to-GDP levels not seen since 1946.

Increased Risk of Credit Downgrades

Many nations which have long held AAA-ratings on their sovereign debt are now at risk of downgrades from the major ratings agencies. As recently as 2007, the average AAA-rated nation had less than 50% gross government debt to GDP; that number is now well above 70%. For 2009, sovereign credit downgrades outnumbered upgrades by a 7:1 ratio. Greece saw its rating fall to BBB+ and is facing the specter of becoming the first developed market to default on its debt since World War II. For now, the burden of dramatically higher yields is limited to Greece, although without a successful solution the possibility of spillover effects to the rest of the European continent cannot be discounted.

Municipals Still Attractive

Closer to home, the anxiety surrounding state and local debt burdens hasn’t translated into

a flight from the municipal bond market. Investors continue to snap up offerings around the country, including in heavily indebted California and New York. Limited relief from the federal government has softened the economic blow for some municipalities; in other cases, a reliance on the Build America Bond program has bridged any difficulty in attracting borrowers. At quarter’s end, California’s general obligation debt offered a yield of 5.69%, better than 1% above comparable maturity U.S. Treasury bonds.

FOREIGN EXCHANGE

The first quarter found the dollar enjoying a long overdue relief rally. During this period, the greenback rallied nearly 6% against the euro and the British pound, while remaining close to neutral against the Japanese yen. Both the dollar and the yen benefited from a flight-to-safety syndrome.

Investors are most anxious about the currencies of countries who have increased sovereign leverage by taking on government debt to promote growth. While the U.S. strongly belongs to this camp, the near-term impact to our fiscal balance pales in comparison to the scale of deficits relative to GDP being generated across the Atlantic. Few, if any, European nations would currently meet the Maastricht Criteria that were the original inclusion standards for European Union membership. Without the ability for individual nations to increase their short-term competitiveness by currency devaluation, market forces have moved to take similar action. In the U.K., the fiscal crisis has become a political issue for Gordon Brown’s government. At quarter’s end, it looks very likely an election will be called for the second quarter, the result of which could be only the second “hung” parliament since World War II.

Japan

Despite coming into this crisis as the most heavily indebted developed market, Japan is experiencing currency strength largely due to the fact that it hasn’t added debt at the pace of the rest of the developed world. Ironically, given

The steep yield curve may be a reflection of credit risk.

Bonds posted modest gains in the first quarter (continued)

the importance of exports to its economy, Japan would actually benefit from currency weakness. Another factor influencing Japan's currency is its proximity to many of the world's strongest and financially healthy economies, which are likely to see currency strength going forward.

China

After a pause, China is likely to resume gradual appreciation of the yuan later this year. However, for the first time in years, China ran a trade deficit during the first quarter of 2010, raising the prospect that China may actually allow its currency to depreciate. We see this as unlikely and at the most would motivate policy-makers to allow the yuan to appreciate at a slower rate. In a fascinating side-note on the changing picture of China in the global economy – in March, General Motors actually sold more cars in China than it did in the U.S.

Overall, we continue to see the greatest prospects for currency strength as coming from the emerging markets, particularly in Asia and Latin America. These countries are experiencing strong growth along with prudent levels of borrowing.

We continue to see the greatest prospects for currency strength as coming from the emerging markets.

Stocks outperformed bonds for the fourth consecutive quarter

Without continued cost cuts, earnings will move lower in the absence of a pick-up in revenues.

After a powerful comeback from the lows reached in March one year ago, the U.S. stock market continued to advance in the first quarter of this year. Stocks outperformed bonds for the fourth consecutive quarter, which put equities at their longest winning streak since 1996 to 1997, when stocks outperformed bonds seven quarters in a row. In general, during the first quarter, smaller capitalization stocks outperformed larger cap stocks, and value outpaced growth. Among the more well known U.S. stock indices, the Dow Jones Industrial Average returned 4.8%, the S&P 500 was up 5.4%, the NASDAQ 100 returned 5.4%, and the S&P/Barra 600 SmallCap Value index was up a healthy 9.9% for the three-month period. Much of the reason for value's outperformance of growth was due to the strength of the financials and industrials sectors, both of which carry large weights in value indices in general.

The stock markets have, without a doubt, climbed a wall of worry. From the lows reached in March 2009, most indices have moved 70% to 100% higher. Corporate earnings have also continued to surprise to the upside. However, there has been a disconnect between growth in earnings and growth in revenues. Last year, corporations exceeded earnings expectations by an amount that had not been seen in a decade, yet the same corporations reported declines in year-over-year revenue growth that had not been seen in half a century.

Earnings Forecasts May Be Too Optimistic

Studies have shown that earnings estimates at the start of a year are generally too high and are usually overstated by approximately 10% on average. This year's estimate is at the very high end of what has been seen historically, with the consensus calling for a 24% rise in earnings. More surprisingly, the earnings estimates are now coming in very close to what they were in 2007. The key question is how reasonable are these earnings forecasts.

It is our view that 2010 looks quite a bit different than 2007 did. While the systemic risks to the

economy might have existed back in 2007, they have been exposed over the past eighteen months. The unemployment rate has more than doubled, moving from 4.6% to almost 10%, mortgage delinquencies are significantly higher, and net worth has taken a big hit. Therefore the debate still continues: Has this stock market rally gone too far too fast? Are these earnings growth rates sustainable? Without continued cost cuts, earnings will necessarily move lower in the absence of a pick-up in revenues. While government programs and stimulus packages might have staved off disaster, they will not be able to replace the robust revenue growth that existed in 2007 without resolution of some of the fundamental issues that face us today.

Identifying Successful Investments

We believe successful investing in 2010 will come by identifying those companies with significant operating leverage which will see a dramatic improvement in margins and profitability when end demand picks up. These companies are likely to outperform their peers.

International stocks also advanced during the quarter

After a remarkable run in 2009, most non-U.S. equity markets continued their ascent in the first quarter of 2010. The MSCI All-Country World index (ex-U.S., net dividends) returned 1.6% in U.S. dollar terms during that time period. The rise wasn't universal though, especially in the developed markets, where fortunes within the European Union have diverged dramatically. Overall, the developed markets only slightly lagged the emerging (+1.3% vs. +2.4%), but beyond that the differences become dramatic. The median developed market lost 1%, while on the emerging side the figure was +4.9%. Only four emerging markets turned in negative results (although two of them were among the largest, Brazil and China). Alternatively, the lower half of developed market results were dominated by Western Europe in general and the PIIGS in particular – Portugal, Greece and Spain each lost better than 10% for the quarter.³

The European story is critical because it vividly points out that investors shouldn't simply measure the extent of their risk by the amount of their emerging markets exposure. Instead, they should take a more holistic approach. As we have long said, the majority of emerging markets entered the current crisis in better financial shape – measured by less consumer, corporate and sovereign debt – than many of their developed peers. Most emerging markets were also experiencing increasing productivity from their youthful workforces, in contrast to declining or stagnating productivity and aging workforces across the developed market landscape.

Impact of European Debt Crisis

Greece seems to be the canary in the coal mine for risks that lurk for other highly indebted Euro-zone nations. So far the acute crises have occurred in the smaller of the peripheral

markets: Ireland and Greece. If the refinancing crisis becomes equally dire in the much larger markets of Spain and Italy, the wealthier nations of Europe – France and Germany – will likely have a much more difficult time subduing global anxiety. The current “mixed solution” of guarantees from the European Monetary Union and the International Monetary Fund (IMF) is working only marginally well in Greece; it is less likely the IMF would lend its support if needed for the larger, more developed European nations.

This crisis highlights the burden much of the developed world will face as it emerges from the global downturn of the past two years. In order to balance budgets in Europe, the U.K. and the U.S., investors are likely to see a generation of higher taxes and reduced stimulus from the government sector. And, while bringing down Greece's budget deficit as a percent of GDP from 12.7% to a more Euro-appropriate 3% to 4% will be painful, the U.K.'s burden to bring down its 12.7% deficit is orders of magnitudes larger. The burdens become greater if these markets face the slippery slope they're currently on – nominal GDP growth well below the interest rates on their debt – for an extended period of time. With long-term investment returns highly correlated with corporate success and GDP growth, we believe the outlook for the developed world is clearly less rosy than for emerging markets.

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³ Returns are based on respective MSCI regional and country indices (U.S. \$, net dividends). Median returns were calculated by Bailard Research.

Commercial real estate values have been written down dramatically

The bursting of the leverage bubble has taken all asset values down dramatically, from homes to stocks to commercial property. While it is likely that almost all these values plummeted nearly simultaneously, commercial property always appears to lag. This is because the appraisal process takes time to find enough transactions on which to base judgments on the amount of the decline.

During the six quarter decline through the end of 2009, the NCREIF National Property Index (NPI) recorded a total return (income and appreciation) of -23.9%. A decline of similar magnitude occurred during the prior crash in the early 1990's, though the appraisal process was "stickier" at that time, and took a total of 20 quarters to unfold. The NPI represents property-level returns only, which are reported as though there were no mortgages on any properties.

Performance of NCREIF ODCE Index

To get a better picture of how investors in general fared over this market crash, we must look to how the NCREIF Open-end-fund Diversified Core Equity (ODCE) index performed. This index covers large commercial real estate funds available to institutional investors, and contains nearly half of the NCREIF NPI properties in their combined portfolios. Since these funds are reporting their actual net asset value returns to investors, the ODCE index's performance takes into account everything the investor experiences – such as the joint-venture share of profits to operating profits, the effect of leverage (debt) on the portfolios, the effect of cash drag and the effect of fund expenses. The ODCE index recorded a -37.8% return over the six quarters ended December 31, 2009 – a figure comparable to the stock market crash's effect on the S&P 500 index from top to bottom.

Real Estate Appears to be Bottoming

Is it over yet? The data appear to be in a leveling off pattern of a long sideways trough. The fourth quarter return for ODCE was only -3.5%. First quarter numbers will not be finalized until near the end of April. What we are seeing now

is that some properties are still being written down as better data becomes available, while other properties are beginning to recover in price, as investors regain more optimism about the future. A few properties, notably in the apartment sector, are starting to see very modest recovery in rental rates, which should serve to nudge property values ever higher. We will examine more of the divergent property-type trends in our next newsletter.

Until then, we think we are getting closer to the point where it will be time to begin rebalancing portfolios that have become underweight in real estate, as a number of institutional investors have already begun to do.

The ODCE index recorded a -37.8% return over the six quarters ended December 31, 2009.

Our investment strategy remains unchanged

U.S. Stocks: Underweight

U.S. stocks moved to a new cyclical high during the quarter after a brief scare from mid-January to mid-February. Earnings once again came in better than expected in March, while signs of economic recovery helped boost investor confidence. The longer term structural problems with debt, mortgage resets, commercial real estate rollovers and inflationary money growth continue to boil on the back burner as investors focus on the near-term betting on a sustainable robust recovery. Our view is that there is considerable risk to that outlook. Stocks, which are now overvalued and overbought, are vulnerable to disappointment. We expect a slow recovery with plenty of downside risk. We have been underweight in equities because of these risks. Although these risks have remained dormant, they have not gone away. Given our discipline of not making heroic bets around our long-term norms, client portfolios have continued to participate in the strong rally since last March.

The economy is showing signs of recovery. Ironically, this poses a new risk – that rising interest rates could jeopardize the nascent recovery and provide stiffer competition for stocks. Nonetheless, stock prices continue to trend higher. The combined wisdom of the market and our discipline to maintain diversified portfolios argues against reducing stock allocations further at this time. If the market were to pull back significantly but remain in an uptrend, we could start adding back to stocks.

International Stocks: Neutral

Foreign markets have moved sharply higher over the last year along with the U.S. market. Emerging markets, which were less scathed by the financial crisis and possess better long-term growth prospects, have rallied the most. Until recently, U.S. based investors in international equities had benefitted from both higher stock prices and from dollar weakness. Unfortunately, the dollar was in a strong uptrend during the first quarter, which has held back international

stock market returns, particularly in the European markets. We continue to see long-term opportunity in international stocks, especially in the emerging markets. However, we are concerned that foreign equities have rallied too far too fast and would be vulnerable to any setback in the U.S. stock market.

Bonds-Underweight

The ten-year U.S. Treasury bond yield ended the quarter about where it was at the beginning of the quarter. However, since then that yield has increased 20 basis points (0.20%) to around 4% as of the time of this writing. The cyclical low was reached in January 2009 at 2.2%. The increase in yields has created downward pressure on bond prices. Fortunately, we have been underweight in this asset class. The rise in bond yields comes on the heels of expectations of stronger growth, Fed tightening and rising deflation concerns. At the same time, at the end of March, the Fed stopped being the primary buyer of Treasury, Agency and mortgage backed securities. Without Fed buying, bond investors are wondering who will absorb the burgeoning budget deficit. The Congressional Budget Office recently revised up its estimates of the federal government's cumulative budget deficits over the next ten years from about \$8 trillion to \$10 trillion. In addition, the trustees of the Social Security Fund reported that the system will be cash flow negative this year, seven years ahead of schedule. This means even more Treasury debt to sell.

Real Estate-Neutral*

There are some preliminary signs that commercial real estate is beginning to stabilize, with bargain hunters coming into the market. Now that valuations are improving, it is tempting to move more heavily into the market. However, commercial real estate is still facing a very difficult economic and financial environment. Rents are continuing to fall and vacancies are still rising. Given our economic outlook, a rapid turnaround in real estate fundamentals is not expected. In addition,

Stocks are vulnerable to disappointment.

Our investment strategy remains unchanged (continued)

the number of commercial loan resets is set to explode, which could be a problem if banks don't find ways to extend new credit. Nevertheless, the worst appears to be over and at some point we will be ready to recommend topping up portfolios.

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 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.

Although a rapid turnaround in real estate fundamentals is not expected, the worst seems to be over.

U.S. INTEREST RATES	6/30/2009	9/30/2009	12/31/2009	3/31/2010
Cash Equivalents				
90-Day Treasury Bills	0.20%	0.12%	0.06%	0.16%
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	0.29%	0.21%	0.06%	0.01%
Bonds				
30-Year U.S. Treasury	4.33%	4.05%	4.64%	4.72%
20-Year AA Municipal	4.84%	3.86%	4.11%	4.14%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 3/31/10	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 Year Treasury Index	1.54%	1.54%	-3.16%
Merrill Lynch 7-10 Year Agency Index	1.93%	1.93%	2.87%
Merrill Lynch 5-10 Year Corporate Index	3.43%	3.43%	28.27%
Barclay Capital Municipal Bond Index	1.25%	1.25%	9.69%
International Bonds			
Citigroup non-US\$ World Government Bond Index, fully hedged	1.11%	1.11%	3.46%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 3/31/10	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	4.82%	4.82%	46.88%
S&P 500	5.39%	5.39%	49.72%
NASDAQ 100	5.44%	5.44%	59.34%
S&P/Barra 600 SmallCap Value	9.94%	9.94%	66.26%
International Stocks			
MSCI Japan, net dividends	8.18%	8.18%	37.87%
MSCI Europe (includes UK), net dividends	-1.80%	-1.80%	56.10%
MSCI EAFE (Europe, Australia, Far East), net dividends	0.87%	0.87%	54.44%

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

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 3/31/10	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-2.11%	-2.11%	-12.17%

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.

Sonya Thadhani, CFA

Executive Vice President, Chief Investment Officer

Amit Valia

Financial Data Management Analyst

Global Economics and Fixed Income

Arthur A. Micheletti, CFA

Investment Strategist and Chief Economist

Mark L. Schemper

Research Analyst, Trader

Domestic Equities

Sonya Thadhani, CFA

Executive Vice President, Chief Investment Officer

Thomas J. Mudge, III, CFA

Senior Vice President, Domestic Equity Research

George Y. Sokoloff, PhD, CFA

Senior Vice President, Director of Quantitative Research

Selena Chaisson, MD

Senior Vice President, Director of Healthcare Investments

Matt Johnson

Vice President, Healthcare Investments

Jane Shi

Investment Analyst

International Equities

Peter M. Hill

Chief Executive Officer

Anthony R. Craddock

Senior Vice President, International Equity Research

Eric P. Leve, CFA

Executive Vice President, International Equity Research

Real Estate Research

Ronald W. Kaiser

Director

Michelle L. Foss, CFA

Senior Vice President, Real Estate

Henry S. Newhall

Vice President, Real Estate

David Abramson

Real Estate Fund Associate

Trading

Glenn A. Davis, CFA

Senior Vice President, Head Trader

Vincent Korta

Investment Operations Analyst

NEWSLETTER PRODUCTION

Janis M. Horne, CFA

Senior Vice President, Newsletter Editor

Celeste E. Andrini

Client and Marketing Associate

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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