

## BAILARD INTERVIEW

### 2010 Year End Review

In this interview, Chief Investment Officer Sonya Thadhani reflects on what happened in the investment markets in 2010. She also offers her outlook for 2011.



**Sonya Thadhani, CFA**  
Chief Investment Officer

*What comes to mind when you look back on the past year or two?*

The past two years have clearly substantiated an often quoted phrase that “stock markets can climb a wall of worry”. After a stunning reversal in 2009, the global equity markets continued their upward climb, albeit with some bumps along the way, in 2010. You may recall that, despite falling precipitously in 2008 and in the first quarter of 2009, U.S. and international stocks shrugged off plenty of worries and moved significantly higher to end 2009 with double-digit gains. Although the recovery in the equity markets had investors breathing a bit easier at the end of 2009, the list of concerns at year end was almost as long as that at the end of 2008.

*What were some of the risks you saw at the start of 2010?*

The biggest risks we saw at the start of 2010 were that financial crises are crippling and typically have long recovery times. While the bursting of asset bubbles is never a pretty phenomenon, the bursting of debt-fueled asset bubbles generally has an uglier end. In the short span of ten years, we have witnessed two significant stock market corrections: the first, in 2000, was when the lofty valuations given to technology, media and

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telecom companies finally ran out of steam; the second, in 2008, was when the global banking system literally came to a grinding halt. The market correction of the early 2000's, while painful, was almost completely confined to the information technology sector. In contrast, the bursting of the housing bubble impacted global economies around the world. Investors still look over their shoulders, wondering what will blow up next.

*What were some of the things that went wrong last year?*

2010 had its share of concerns raising their ugly heads through the year. Some problems were foreseen, and some came out of nowhere. Among the foreseen problems were concerns about a sustainable economic recovery in the face of stubbornly high unemployment, questions about the existence of a housing recovery, consumer deleveraging, sovereign debt issues that threatened the ability of the European Monetary Union to survive unscathed, growing deficits and no clear signs of economic improvement. These worries had investors shunning risky assets all through the second quarter. Then there were the unforeseen problems. The British Petroleum oil spill dumped 4.9 million barrels of crude into the Gulf of Mexico in what the President called the "worst environmental disaster America has ever faced". Travelers, who weren't aware that Iceland had volcanoes, became all too familiar with the perils of flying through volcanic ash. Approximately ten million people are believed to have been impacted by the volcanic eruption as a result of 100,000 flight cancellations. And then, as if the precipitous drop of 2008 wasn't enough to rattle investors, they experienced a "Flash Crash", in which stock markets plunged at startling speed in a few minutes on May 6th. The result? The global equity markets lost their footing and, at mid-year, most markets were in the red.

*Despite these concerns, the equity markets ended the year in the black. To what would you attribute that?*

Much of 2010's returns came in the second half of the year and, more specifically, in the last

four months of the year. Corporate earnings and revenues generally surprised to the upside. As a result of intense cost cutting and aggressive inventory management, corporations posted operating margins that were significantly better than expected. American businesses are now holding cash equal to 14.6% of their total net worth on their balance sheets, significantly above the long-term average of 8.9%.

*Does this mean U.S. stocks are likely to continue to rally?*

Corporate cash holdings could be used to increase capital expenditures, grow dividends, buy back stock, boost merger and acquisition activity or to increase hiring. Any improvement in the unemployment picture would likely come as a positive surprise to the equity markets. Still, we shouldn't jump to any conclusions. Corporations may very well use their cash prudently and judiciously until the macroeconomic picture becomes a good deal brighter. The litany of concerns hasn't gone away. If anything, as the stock markets have climbed higher, one worries a bit more that much of the corporate "good" news has been priced into today's valuations.

*Fixed income, especially on the municipal front, has been a headline grabber over the past few months. Can you comment on that?*

The state of the municipal market has become particularly concerning to investors. Muni bonds dramatically underperformed every other sector of the fixed-income market at the end of 2010. During the course of the year, the municipal bond market underperformed corporate bonds by 9% (based on the BarCap Muni Bond index and the Merrill Lynch 5-10 Year Corporate Bond index). Despite this underperformance, municipal bonds are not terribly oversold given the budget and fiscal imbalances that state and local municipalities across the nation are facing. The extension of the Bush tax cuts also does not help the relative attractiveness of these tax-exempt instruments for taxable investors.

Some states are far worse off than others. The general obligation bonds of these states have seen their five-year credit default swap (CDS)

Investors still look over their shoulders, wondering what will blow up next.

## 2010 Year End Review (continued)

spreads\* inch closer to that of high yield debt as a result of the increased perception (or reality) of risk. 2011 might very well be the year where some serious thought has to be given to how these municipalities will meet their bond obligations.

It may seem far-fetched for a state to consider restructuring its debt, given its ability to increase taxes and presumably its revenue. States can also count on having the backing of the federal government which, up until now, has been considered the ultimate safety net. Although all of this is true, the mismanagement of state finances in certain parts of the country has been so significant that it might take a combination of tax increases, austerity measures, and possibly even concessions from public employees and bondholders to actually resolve this problem.

### *What are you looking for in the coming year?*

2011 will be a balancing act. As you know, we are fortunate to work with a team of very capable investment specialists who cover international equities, U.S. equities across the size and style spectrum, long-short strategies, tactical asset allocation and direct commercial real estate. Tapping into the collective wisdom of these resources, our biggest concern remains the extraordinary burden of “debt” in today’s developed world. Whether the debt is U.S. municipal, U.S. federal or European sovereign, it is likely to prove the most significant threat to prosperity and stability.

But we see opportunities too in the year ahead. The U.S. and other developed economies, although heavily burdened by public sector debt, continue their struggle back to better growth. Emerging markets are still leading the world’s economic growth, part of a long-term economic power shift. Small cap growth stocks (for example, those in the emerging life sciences arena) have very positive momentum and we believe look set to move higher. Technology stocks are cash rich, with plenty of room for new investment and takeovers. Commercial real estate continues to recover as the improving fundamentals of the economy “catch up” to the cap rate compression that we saw through the course of 2010. Near term, our tactical asset

allocation models remain bullish on higher beta (i.e. riskier) equity styles, suggesting liquidity is finding a home in the equity market. There are also signs that rationality is returning to the market - that is, that the quality of earnings and balance sheet is once again important.

Global capital imbalances (emerging markets “savers” versus the developed world “debtors”) suggest volatility will remain in the year ahead. But, in the next twelve months, we believe the markets have a little farther to go to complete their climb of the current “wall of worry”. As a result, there should be further opportunities across the different asset classes and strategies.

\*A bond CDS spread is a measure of the cost of buying, though a contract with a third party, protection against the risk of that bond defaulting.

2011 will be a balancing act, but there should be further opportunities across the different asset classes and strategies.

# The U.S. economy remains in a slow growth mode

We think it is most likely that the economy will continue to experience slow growth, with plenty of downside risks.

This quarter we are merging the U.S. and International economic sections into one section that focuses on conditions here in America. A number of issues facing the U.S. are global in nature; more importantly, as the world's largest economy, what happens in America will have a significant impact on economic growth overseas.

Over the last year, we have been calling for a slow growth recovery in the U.S. In general, that is what we have seen. Economic growth through the first three quarters of 2010 averaged a below-trend 2.6%. Real final sales, which takes out inventory accumulation over the same period, was an anemic 0.9%.

## Confidence is Improving

Although there is some hope for stronger growth in 2011, this is by no means certain. When we developed our stronger growth scenario last year, we envisioned a post-election shift in confidence, starting in the business sector. We believed an extension of tax cuts and the hope of greater fiscal discipline and regulatory restraint could serve as catalysts for stronger business confidence. November and December saw such a shift, as both the NFIB Small Business Optimism Index and the six-month outlook from the regional manufacturing indices rose. In our scenario, an upturn in business confidence would lead to an increased willingness to add new workers, with greater job security in turn resulting in increased consumer confidence. Although consumer confidence did see some improvement in December, most of the indices we monitor are turning up from very low levels.

## Downside Risks Remain

It is still too early to tell if this revival of confidence is a short-term phenomenon or a sustainable trend. The U.S. economy still faces plenty of headwinds, many of which are structural problems that will likely take time to resolve. For the first time in a long while, we can see glimpses of light at the end of the economic tunnel. However, we think it is most likely the economy will continue to experience slow growth with plenty of downside risks. We

have had false starts before and need to be cognizant of the imbalances that threaten the sustainability of the recovery. Let's take a look at some of these imbalances and downside risks:

1. **Consumption is growing faster than income.** Anemic employment growth, low wage growth and a slowing in government transfer payments are keeping a lid on consumer income growth. Despite this weakness, the consumer has found ways to continue to spend, most notably by saving less. Unfortunately, a lot of the strength in spending has come from higher prices for food and energy. Excluding food and energy, personal consumption growth is at an all-time low of less than 1% year over year. The spending we are seeing is not discretionary but out of necessity. When consumption exceeds income for a prolonged period, growth is usually unsustainable.
2. **The unemployment rate is likely to remain high.** The key to stronger consumer spending is job growth. While that is likely to be better this year than last year, it probably won't put much of a dent in the unemployment rate. In normal times, the U.S. economy needs to generate approximately 150,000 net new jobs per month (or 1.8 million jobs per year) just to absorb new labor force entrants. Last year only 840,000 jobs were created, while over the last two years 4.5 million jobs have been lost. The unemployment rate hasn't been higher because many people have left or chosen not to enter the labor force and thus are not counted as unemployed. This creates a backlog of potential workers. As job conditions improve, these people will also be reentering the labor force. Faster growth in the labor force will likely keep the unemployment rate high.

This creates a problem for the long-term unemployed. The number of people whose unemployment benefits run out after 99 weeks will probably continue to grow. Over the next six months, the number of '99er's could increase at a rate of about 500,000 per month.

# The U.S. economy remains in a slow growth mode (continued)

3. **Energy and food costs are rising.** Everything else being equal, higher energy and food costs will act to reduce consumer purchasing power and real consumption while simultaneously boosting inflationary pressures. Since early June, oil prices have risen 35% to over \$90 per barrel, while agricultural commodity prices (including livestock) have risen over 60%.
  4. **The consumer is still deleveraging.** While the consumer has made notable progress in deleveraging, we do not believe this process is over. Delinquencies, foreclosures and bankruptcies remain near record highs. The household debt-to-income level, while improving, is also still well above normal levels. Taking on more debt to boost consumption does not seem like a viable option for the consumer at this time.
  5. **Housing is double dipping and mortgage rates are rising.** Home values are in the process of heading lower in the U.S. and appear vulnerable elsewhere in the world, especially in Australia, the U.K., Spain, Canada and China. Although there may not be a lot of downside risk left in housing, there is a very real risk that rising mortgage rates, oversupply and continued deleveraging could cause a negative overshoot – that is, that housing prices may decline more than the fundamentals would dictate. In the next year, we may see another surge in foreclosures as current moratoriums are lifted and banks play catch-up.
  6. **The deleveraging of federal government debt has not even begun.** The federal government is in a deep hole due to its high debt levels. The steps required to climb out of that hole will likely cause short-term pain but yield long-term benefits. The size of the federal government clearly needs to shrink. We are past the peak in federal stimulus, which is a start to getting spending under control. However, controlling spending will not be easy. There is a strong likelihood that bipartisan bickering next year will create gridlock. However, that might be a welcome relief compared to out-of-control spending.
- Although the recently passed tax compromise has been held out as a second stimulus package, it will likely provide little stimulus. The extension of the Bush tax cuts removes a potential negative but is not a stimulus. No one's after-tax income is going to increase. The extension merely keeps after-tax income from going down. Similarly, the \$115 billion, 2% payroll tax cut should not create much of stimulus. It only adds about \$15 a week to the average worker's paycheck and is largely offset by the elimination of the Make Work Pay program.
7. **U.S. state and local governments have deficit problems of their own.** 2011 will likely be a year of non-stop "municipal crisis" headlines, as state and local governments move aggressively to cut expenditures and to balance budgets. One of the biggest issues for municipalities will be addressing their public employees' pension problems. A recent study by Robert Novy-Marx of Rochester University and Joshua Rauh of Northwestern University found that major pension plans for city workers have a combined estimated underfunding of \$574 billion. The problem is even worse at the state level. Of 116 major pension plans sponsored by the 50 states, the unfunded liabilities total between \$1.8 trillion and \$3.4 trillion, depending upon the assumptions made.
- In addition, the states can no longer count on a federal bailout. Congress stopped bailing out states last year. For example, California's request for an \$8 billion bailout was rejected. Given the results of last year's elections, the new Congress is unlikely to provide financial aid other than as a quid pro quo for strict austerity measures. As a result, this year there will likely be a significant fiscal drag from state and local governments, which together account for about 13% of GDP. Higher taxes, fees and fines, as well as lower expenditures from these sectors, are clearly a downside risk.
8. **There is still sovereign debt risk in Europe.** Sovereign debt risk returned into focus

# The U.S. economy remains in a slow growth mode (continued)

International growth engines are tightening.

recently, as Moody's downgraded Ireland's government debt five notches to Baa1 from Aa2. The credit rating agency is also keeping Ireland on the negative credit watch list. The credit problems have spread to Spain, Portugal and even into the core of Europe, with Belgian yields rising sharply. Although the European Central Bank (ECB) is now planning to double the size of its capital cushion in response to the spreading sovereign and bank credit problems, until Germany gets on board, pressure will likely remain. The cash infusion is a temporary bandage that does not resolve the banking and economic problems that are besetting Portugal, Ireland, Italy, Greece, and Spain (the PIIGS).

Austerity or complete bailouts are the two difficult policy choices on the table. Austerity risks sustained economic weakness and social unrest. The bailout option requires Germany, as the white knight, to act as a backstop to other countries' debt. At this point, Germany needs to decide whether it wants to be German and abandon the euro, or be European and dilute its credit quality for the good of the union. The citizens of Germany are adamant about not paying for the "sins" of others. They were willing to bear the cost of unification of Germany but are unlikely to be willing to bear the cost of unifying with strangers. The dilemma for Germany, France and others is that, if the PIIGS go under, given the interconnectiveness of the European banking system, German and French banks could be pulled down with them.

The current situation puts the euro at risk. While the ECB and the International Monetary Fund may be able to buy more time, a breakup of the euro or a comprehensive European debt restructuring currently seem to be the only viable long-term options.

9. **International growth engines are tightening.** Brazil, Russia, India and China (the BRICs) are all tightening monetary policy to contain inflation. Brazil has

raised the overnight rate three times this year from 8.64% to 10.66%. It recently announced a commitment to raise rates further, as the outlook for inflation has become "far less favorable". Brazil's inflation rate has risen to 5.6% year over year in November from a low of 4.2% a year ago. Russia's central bank raised the interbank deposit rate to 3.25%; with inflation up 8.1% year over year, more rate hikes are likely. China has also been aggressively raising bank reserve requirements and interest rates as inflation topped 5% year over year in November. India has increased the overnight rate 150 basis points (1.50%) since March to 6.25% with wholesale inflation rising above 8%. Rates are probably not high enough yet to materially slow growth but more tightening is likely. Although higher inflation is one reason for tightening, the BRICs are also concerned about "hot money" flows and asset speculation developing as a result of the Fed's new round of quantitative easing (QE2).

10. **What's after QE2?** The Fed's current QE2 policy marks the third time in the last twelve years that the central bank has tried to create an asset bubble and halted an unwinding of the debt bubble. On December 13, 2010, Thomas Hoenig the head of the Kansas City Fed called QE2 "a bargain with the devil." According to Brian Sack of the New York Fed, the Fed is openly trying to manipulate markets by purchasing longer term U.S. Treasury debt and "keeping asset prices higher than they otherwise would be." Although QE2 is helping to boost equity prices, to date it has had little impact on economic growth.

The quantitative easing program is scheduled to expire at the end of June. What will the Fed do for an encore? Without artificial stimulus, how will asset prices respond? Who will buy the Treasury's debt if the Fed stops making purchases? Foreigners are becoming increasingly reluctant to hold more U.S. debt. U.S. pension funds don't have the cash to invest, and individual buyers are starting to sell. Perhaps higher yields will attract new buyers. However, we

# The U.S. economy remains in a slow growth mode (continued)

believe the only real long-term solution is to cut government spending.

So, while we are seeing signs of economic life outside of inventory accumulation and government spending, the recovery is fragile and the U.S. economy must deal with a number of potential headwinds. This will require a rebuilding of confidence. Without confidence in the future, business will not hire and expand, and consumers will not spend.

The recovery is fragile and the U.S. economy must deal with a number of potential headwinds.

# Bonds declined in the fourth quarter

The government bond markets reacted negatively to the Fed's second round of quantitative easing.

The fourth quarter marked the end of the downward trend in yields experienced for the prior two quarters, as the government bond markets reacted negatively to the Fed's second round of quantitative easing. Yields on 30-year U.S. Treasury bonds rose 0.25% for the quarter, bringing the rate to 4.4%, almost 2% above the lows reached in the fall of 2008. QE2 has, so far, turned in ambiguously positive results. Although it failed to bring down long-term interest rates as originally intended, it seems to have been successful in boosting confidence and reinvigorating the U.S. stock markets.

During the fourth quarter, the Merrill Lynch U.S. Corporate, Government and Mortgage Master index, (a broad measure of taxable bond performance) fell a modest -1.7%. However, based on their respective Merrill Lynch Master indices, long-term Treasuries fell almost -9% and municipal bonds fell more than -4.5%.

## Municipal Bonds

Municipal bond investors experienced sharply higher yields for the quarter and for the year as a whole. Much of the downward pressure during the fourth quarter was exerted by a large issuance of Build America Bonds just before the scheduled expiration of the program in which the federal government pays a portion of the interest on new municipal debt. The fear, which came to pass, was that the program wouldn't be included in Congress's year-end extension of tax breaks.

More fundamentally, budget crises are becoming more prevalent around the country. Illinois has joined California with the ignominy of having the lowest state credit ratings. The situation in Illinois is far worse than California, though, with a deficit amounting to about one-half of its total budget and no solution to funding the state's pension plan. For the past six months, the pension plan has been selling assets to pay benefits. Tax collections have improved slightly in California, which, unlike Illinois, does not face a negative outlook from the ratings agencies. Overall, even after three difficult years, actual defaults of municipal debt continue to be typically low, at 0.15% of the total market as of December 1, 2010.

## FOREIGN EXCHANGE

Higher commodity prices provided a backdrop for strength in many foreign currency markets during the fourth quarter. The currencies of New Zealand, Australia, South Africa, Chile and Canada all were among the strongest performers. The euro, which had been very volatile all year, declined -1.7% versus the dollar during the fourth quarter. However, it ended the year with an inkling of strength by rising from below \$1.30 to \$1.34 in the month of December. Eastern European currencies were the weakest globally for the quarter, as a lack of resolution to their structural deficits weighed on the Polish, Hungarian, Czech and Turkish markets.

Since the sovereign debt crisis in Europe does not yet have a clear resolution, we expect further volatility in the euro in 2011. A permanent fund has been agreed upon to deal with sovereign defaults after the current program expires in 2013. However, it may yet prove insufficient if larger markets such as Spain or Italy come under distress.

# U.S. stocks ended the year with double-digit gains

Readers of this publication may remember the market environment six months ago, at the end of the second quarter of last year. The S&P 500 and NASDAQ 100 indices had both declined more than -6% in the first half of 2010. Small cap value stocks, as measured by the S&P/Citigroup 600 Small Value index, were also down just under -2%. Weighing the positives and negatives at the time, we noted that, while “current market prospects do not appear particularly exciting”, U.S. stocks were likely to experience “close to a typical equity return year” (with typical being in the ballpark of the long-term index averages of +10% for large cap stocks and +12% for small cap stocks.)

As it turned out, our optimism was a little too bridled, thanks to robust returns in the second half of 2010. The S&P 500 index finished the year up 15.1%. The NASDAQ 100 fared even better, rising 20.2%. The best performance came from the S&P/Citigroup 600 Small Value index, which advanced 25.0% in 2010. What drove the upside? Strong positive third quarter earnings surprises and a more business friendly political climate were probably the biggest contributors.

## Outlook for 2011

Looking ahead, what can we expect for domestic stocks in 2011? Our best guess is more (or slightly less) of the same. Valuations remain fair to very slightly inflated. Earnings prospects are improving as the economy slowly rebounds. Investor sentiment is the only current negative, since it is hovering in excessively optimistic territory. Based upon these measures, a fairly typical return year seems warranted. What could derail our mildly optimistic forecast? In the words attributed to former British Prime Minister Harold Macmillan, “Events, my dear boy, events.”

## Potential Risks

As was the case last year, there are numerous potential “events” that could undermine or stymie positive U.S. equity returns. An economic slowdown would be our number one concern. While the economy appears to be gaining traction, growth is slow enough that there is still the potential for a double dip recession. Numerous governments, both here in the form

of states and municipalities, and abroad in the form of entire nations, remain on the brink of insolvency. Should a debt crisis occur, it is likely to have a negative impact on U.S. equity markets. Political turmoil also could unsettle investors, with Pakistan, Iran, Afghanistan and North Korea leading a long list of potential trouble spots in 2011. However, the reality is that, although there is always something to worry about, most often, we muddle through.

What can we expect for domestic stocks in 2011? Our best guess is more (or slightly less) of the same.

# International stocks advanced in the fourth quarter

The developed markets generally saw a broad dispersion of returns along the sovereign risk spectrum.

The international equity markets turned in generally strong results for the fourth quarter. The MSCI All Country World ex-U.S. index (net dividends, U.S. \$ terms), delivered investors a 7.2% return for the period. Developed markets, as measured by the MSCI EAFE index (net dividends, U.S. \$ terms) rose 6.6%, while emerging markets, as measured by the MSCI Emerging Market index (net dividends, U.S. \$ terms) advanced 7.3%. Not surprisingly, the worst European returns were for Greece, Spain, Belgium, Italy and Portugal, countries whose stock markets have been adversely affected by the sovereign debt crisis.

## INTERNATIONAL THEMES

The international stock markets were driven by a range of factors over the past quarter. For many investors, the U.S. mid-term election was focal, given that a change in control of Congress could have major impacts on fiscal policy, which, given the scale of the U.S. economy, has broad implications across the world. The sovereign debt crisis in Western Europe flared up again, riled by a \$90 billion bailout of Ireland. Early in the quarter, one of the market's greatest worries was the strength of emerging market currencies; by quarter's end, it was that China's focus on restraining inflation would come at the cost of domestic and international growth.

## DEVELOPED MARKETS\*

As was true for 2010 as a whole, during the fourth quarter, the developed markets generally saw a broad dispersion of returns along the perceived sovereign risk spectrum. The safe plays fell into many camps: Germany and Switzerland as strong exporters with relatively little sovereign debt, Norway and Canada due to rising oil prices and good fiscal responsibility, and Japan for its independence from much of the turmoil the rest of the world has faced this year. November's G-20 meeting at Seoul laid the groundwork for rational workouts to future sovereign debt crises in Europe. Countries experiencing a liquidity crisis would get assistance from European relief funds, while those with a true structural debt crisis would see bondholders bear some of the burden of the workout. In this environment, highly

indebted markets suffered this quarter, along with Belgium whose debt-to-GDP is, and has historically been, high by European standards.

The highly indebted countries face long-term structural issues which policymakers are hesitant to attack. Much of the work done across Southern Europe involves balancing budgets over the next year; the real work of increasing worker participation rates among the middle-aged (including those in their mid-60's) has stagnated. Reforming pension and health plans and encouraging labor mobility are also critical to long-term success in the broader euro region. As these countries de-lever from their generation-long debt binge, pro-growth policies and a greater dependence on exports will be required to maintain even a low level of growth. While these countries' stock markets are "cheap" by relative measures, it has not yet been prudent to invest in them.

## EMERGING MARKETS\*

Latin America was one of the laggards among the world's emerging regions in the fourth quarter. A smooth national election in Brazil didn't help against a backdrop of a strong currency which dampened exports.

Elsewhere, Eastern Europe would have looked much worse without the 16.5% returns Russia produced during the period. Many of the Eastern European markets are facing budget pressures akin to those facing Western Europe. Hungary in particular has roiled the markets with short-sighted attempts to restore a balanced budget by extending industry-specific taxes and nationalizing private pensions. Both of these actions have been met with scorn by global investors and ire by residents. In addition, the weakness of the Hungarian forint relative to the Swiss franc (the denomination of most home mortgages originated from 2005 through 2007), has left most borrowers "underwater" with a high risk of default.

While turning in poor investment results for the quarter, Turkey is weathering the downturn better than many of its neighbors. It is the only one to have increased net exports through the past few years as expanded relations with

# International stocks advanced in the fourth quarter (continued)

markets to the South and East have more than offset the shortfall from Western Europe.

\*Return comments are based on the appropriate MSCI index (net dividends, U.S. \$) for each country or geographic region.

# Real estate is beginning to recover

We are likely to see a gradual shift in price recovery from fully leased properties in major metro areas, to properties that are under-leased or in less than A+ markets.

Transaction levels in commercial property continue to recover, even though the recovery in net operating incomes is only beginning to be apparent in the apartment sector. Transaction volumes in the U.S. are likely to top \$100 billion for the year 2010, according to Real Capital Analytics. This is nearly double the levels of depressed 2009. And, recent surveys indicate that investors will put more properties on the market in 2011 and will maintain their healthy appetite for new acquisitions. However, it will be some time, if ever, before we see a repeat of the record \$514 billion volume of 2007. As a result, there should continue to be some upward pressure on prices (i.e., lower cap rates).

under-leased, lower-priced properties that need some “value added” efforts by management.

## Real Estate Less Attractive Relative to Bonds

Mitigating against a further reduction in cap rates is the recent rise in interest rates. As investors began to believe the economic recovery really is coming, they have driven yields on ten-year U.S. Treasury bonds from their autumn lows of 2.5% to 3.5% today. Real estate is still reasonably priced, but no longer excessively cheap versus bonds. Instead, what we are likely to see is a gradual shift in price recovery from fully leased core properties in major metro areas, to properties that are under-leased or in less than A+ markets.

## Net Operating Incomes an Issue

In order for real estate to continue its price improvement, properties’ net operating incomes will need to increase. We are beginning to see this in many apartment markets as jobs increase and people can afford to move out of crowded shared housing situations. This job effect will be delayed, however, in office buildings, as many employers will need to first refill their already empty spaces brought about through layoffs. Industrial demand recovery will also first require growth in business sales and inventories. Retail will likely be the laggard, as consumer spending is not expected to lead the way to economic recovery any time soon.

## Strategy for 2011

Thus, the strategy for 2011 appears to be to sell prime core properties into those strong sellers’ markets that exist, and to redeploy capital into

# We increased our allocation to global equities and decreased our allocation to bonds

Bailard's investment strategy worked quite well during the last quarter. Our adjustment to our strategic (three to five year time frame) norm in September was well timed. We lowered our bond and core U.S. equity weightings, while increasing our allocation to international, small cap value and large growth stocks. Since the adjustment, bond yields have risen sharply and prices have fallen, while small cap value and large cap growth stocks as measured by their respective indices have outperformed the S&P 500. International stocks as measured by the MSCI All Country World ex-U.S. index (net dividends, U.S. \$) have also provided a solid return. Finally, we reduced our position in gold over the course of the quarter from 40% of the Tactical Asset Allocation pool to about 20% at the end of the quarter. Although gold has recently underperformed a broader basket of risky assets, it still plays a vital role in our portfolios. If the "risk" bet becomes unpopular again or if inflation fears resume, our position in gold should serve portfolios well.

## U.S. Bonds: Underweight

We reduced our exposure to bonds in October, a move which was very timely. QE2, which was intended to bring down long-term interest rates, did just the opposite over the course of the fourth quarter. The downward trend in yields came to a halt and bonds of every ilk lost value. Long-term treasuries and municipal bonds were among the hardest hit.

## U.S. Stocks: Overweight

After trending lower between April and September, U.S. stocks rebounded sharply in early September. We sought to capture the move higher by reallocating some capital out of long dated Treasuries and investment grade corporate bonds into some of the high beta areas of the U.S. equity markets. In particular, we added to our weighting in small cap value and large cap growth stocks. Additionally, the strategic norm was modified to decrease the weight of the U.S. core equities and to increase the weight of these two higher beta areas. The move was very timely as much of 2010's equity returns came in the last four months of the year.

## International Stocks: Overweight

We added to our position in emerging markets at the start of October, but gradually reduced our weighting by the early part of December. We still maintain exposure to emerging markets in addition to our core international equity portfolios largely due to some strategic tailwinds that we think will benefit emerging market equities over the long run. Although international stock markets performed well during the fourth quarter, emerging markets suffered some in part due to strong currencies and fears that China's efforts to curb inflation would have a negative impact on global growth.

## Real Estate: Neutral\*

There were signs of life in the real estate market in 2010. The fourth quarter brought with it continued improvement in transaction levels and a firming in pricing. Much of the cap rate compression (i.e. price improvement) that we saw in 2010 came in core, stabilized properties where fundamentals haven't quite caught up to current market values. We started the quarter with some additional exposure to public real estate but removed that exposure during the course of the quarter. In order for real estate pricing to continue to rise, we believe there must be some real improvement in operating fundamentals.

## Alternative Investment Strategies: Neutral\*

Market neutral, long-short strategies are an attractive investment alternative to cash and bonds for the appropriate group of investors. We have maintained our strategic allocation to this asset class.

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

Bailard's investment strategy worked quite well during the last quarter.



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<b>U.S. INTEREST RATES</b>	3/31/2010	6/30/2010	9/30/2010	12/31/2010
<b>Cash Equivalents</b>				
90-Day Treasury Bills	0.16%	0.18%	0.16%	0.13%
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	0.01%	0.09%	0.10%	0.06%
<b>Bonds</b>				
30-Year U.S. Treasury	4.72%	3.89%	3.69%	4.34%
20-Year AA Municipal	4.14%	3.95%	3.79%	5.09%

Sources: Datastream International and Bloomberg, L.P.

<b>GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 12/31/10</b>	<b>QUARTER</b>	<b>YEAR TO DATE</b>	<b>ONE YEAR</b>
<b>U.S. Bonds</b>			
Merrill Lynch 7-10 Year Treasury Index	-4.27%	9.31%	9.31%
Merrill Lynch 7-10 Year Agency Index	-2.49%	9.87%	9.87%
Merrill Lynch 5-10 Year Corporate Index	-1.82%	11.27%	11.27%
Barclay Capital Municipal Bond Index	-4.17%	2.38%	2.38%
<b>International Bonds</b>			
Citigroup non-US\$ World Government Bond Index, fully hedged	-2.05%	2.48%	2.48%

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

<b>GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 12/31/10</b>	<b>QUARTER</b>	<b>YEAR TO DATE</b>	<b>ONE YEAR</b>
<b>U.S. Stocks</b>			
Dow Jones Industrial Average	8.05%	14.10%	14.10%
S&P 500	10.76%	15.09%	15.09%
NASDAQ 100	11.28%	20.16%	20.16%
S&P/Citigroup 600 Small Value	16.19%	25.01%	25.01%
<b>International Stocks</b>			
MSCI Japan, net dividends	12.12%	15.44%	15.44%
MSCI Europe (includes UK), net dividends	4.50%	3.88%	3.88%
MSCI EAFE (Europe, Australia, Far East), net dividends	6.61%	7.75%	7.75%

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

<b>REAL ESTATE TOTAL RETURNS (US\$) THROUGH 12/31/10</b>	<b>QUARTER</b>	<b>YEAR TO DATE</b>	<b>ONE YEAR</b>
NCREIF National Property Index*	5.45%	15.75%	15.75%

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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## NEWSLETTER PRODUCTION

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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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