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A Quarterly Review of Economic and Market Developments

4TH QUARTER 2007

BAILARD INTERVIEW

Half Empty or Half Full?

Bailard's Chief Economist Arthur A. Micheletti discusses his outlook for 2008.

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Given the growing list of economic problems, what is your outlook for the New Year?

The U.S. does face many problems, including a housing recession, a credit crisis, high oil prices, stagflation fears, election year uncertainty and geopolitical risks. While many prognosticators believe the economy is on the verge of recession, I still think the economy will bend but not break – that it will slow but continue to surprise everyone with its resilience. If there is a recession, I expect it to be mild.

Why are you so optimistic?

I think many commentators overstate the risks and ignore positive developments. By the time problems are widely recognized, they are often well on the way to being resolved. Moreover, it is human nature to extrapolate current negative events into the future, particularly when the news media reinforces investor fears. My biggest concern is that we talk ourselves into a recession that otherwise need not have happened.

How so?

Take the subprime credit problem. Since our analysis suggests that the writedowns for bad debt pose no solvency or liquidity risk to the economy and banking system, the biggest risk is a failure of confidence. While writedowns could ultimately total $200 billion, this is only

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Half empty or half full?

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a half a year's earnings for the financial sector and only 1% of its $20 trillion in assets. Losses are spread globally over many investment portfolios, so that public companies should not feel all the pain. Banks are extremely well collateralized, with TIER 1 Capital (Equity/Assets) of 9.6% at the end of the third quarter, well above the required 6%. Finally, financial institutions are receiving large capital infusions from both foreign and U.S. investors looking to buy cheap assets.

Isn't the recession in housing starting to spread to the rest of the economy?

Housing is and has been the major drag on the economy but, unlike past cycles, it has not led to a recession. Over the last four quarters, housing has subtracted 1% from overall economic growth. The weakness in housing has been offset by, among other things, disciplined monetary policy, service sector growth, technological innovation and global economic development, which allowed net exports to grow enough to add 1% to our GDP last year.

Won't the U.S. slowdown derail global growth?

While weakness in U.S. growth will likely have a dampening effect on the global economy, its impact shouldn't be overestimated. Overseas growth is no longer solely dependent upon exports to the U.S. The end of the Cold War and spread of free market capitalism have opened up new opportunities for development overseas. As countries such as China and India transform from agrarian based to industrialized and service oriented economies, improving living standards, rising consumer incomes and huge infrastructure investments are increasing domestic demand. Over time, the U.S., which now accounts for about 35% of global GDP, is likely to shrink in importance.

Won't housing woes and high oil prices undermine consumption?

Thanks in part to the resilience of the consumer, the U.S. economy has continued to grow despite two years of rapidly rising oil prices and weakness in the housing sector. Employment growth is still positive (albeit slower), and personal income is increasing at a 6% rate. As long as incomes are rising, the consumer should continue to spend and the economy is likely to move forward.

Doesn't the high oil price eat into consumer spending?

Yes, but energy consumption as a percent of personal consumption has fallen over time. It peaked at 9.5% in 1980, fell to 4.25% in 2002 and, with oil prices increasing, has risen to about 6.25%. Over the last five years, oil consumption has stripped only about 2% (0.4% per year) from consumer spending.

Given all of these problems, what could go right?

If home prices and mortgage rates continue to fall, increased housing affordability could lead housing activity to reaccelerate later in the year. Current oil prices are not supported by the supply-demand fundamentals and appear to be driven by speculation. Prices could drop sharply, particularly if OPEC increases production. The ongoing credit crunch could ease as the underlying problems are addressed with significant writedowns, capital infusions and a freezing in subprime mortgage rates. Finally, positive developments in Iraq and troop withdrawals could reduce geopolitical concerns.

From an investment perspective, what do we do now?

We believe it is more important than ever to adhere to our investment disciplines, including maintaining diversified portfolios, monitoring events closely and judging the attractiveness of each asset class on the basis of valuations, the economic environment and market trends. We remain overweight in global equities. They are reasonably valued, and a slow growth, easier monetary policy environment would likely allow that value to be unlocked. However, since the end of the year, the long-term stock market trend has started to roll over, giving us a precautionary bias to sell into rallies.

The U.S. economy is slowing

Final third quarter 2007 GDP growth was revised from its original 3.8% to a more robust 4.9% annualized rate. The adjustment was due to an upward revision in net exports and inventories. This was the fastest quarterly GDP growth rate in four years and pulled the year-over-year number up to 2.8%. The GDP deflator (inflation) was revised slightly higher to 1.0% from 0.9%, bringing the year-over-year number to 2.4%.

Growth likely slowed significantly in the fourth quarter of 2007. Most commentators expect growth to continue to slow into the New Year, and some analysts are looking for a recession. We remain in the slow growth camp.

Consumers keep spending as income and balance sheets look strong

Consumer spending accounts for about 70% of GDP growth. As long as consumer spending continues to grow, the economy is likely to avoid a recession. Consumer spending surged 1.1% in November, and real consumer spending grew at a healthy 3.6% annualized rate for the trailing three months. Preliminary reports for December indicate that holiday sales were solid but not spectacular.

Employment growth has slowed but it is still positive. Payroll employment as of November was rising at just above 1% year over year, the slowest pace since 2004. Personal income (which combines employment growth, hours worked, and wages) was still growing at a 6.1% year-over-year pace. Personal income and consumption growth are likely to slow over the coming months as layoffs in the finance sector continue.

Despite concerns about subprime mortgages, household balance sheets remain solid. At the end of the third quarter of 2007, household net worth was a record $58.6 trillion. Financial net worth (excluding real estate assets) was $31.1 trillion. Households have plenty of liquidity as well, with $7.1 trillion in cash-like assets.

Global economic strength has offset the drag from housing

Over the last four quarters, housing has subtracted about 1% from GDP growth. Fortunately, the booming global economy has boosted export growth. Exports are now growing faster than imports. Net exports have contributed about 1% to GDP growth, completely offsetting the housing drag. As discussed in the interview section of this newsletter, global economic strength (particularly out of Asia) is likely to continue despite a growth slowdown in the U.S.

Housing should remain weak, but the stage is being set for recovery

Since housing weakness subtracted about 1% from GDP growth over the last year, a mere stabilization of the housing sector would add 1% to growth. Housing has been in a recession for two years, with construction down 33%. Household formations have continued to grow and pent-up demand is building. As interest rates and home prices have declined, housing affordability has improved significantly. If prices fall a bit more and interest rates remain low, conditions for satisfying some of this pent-up demand should be in place.

The demographics for the housing sector remain positive. The 35 to 45 year-old age group is currently the largest cohort at 15% of the population. The median age of the population is 36.5 years. This is the prime earning and home ownership age. In addition, current and past immigration trends should support housing. Currently, 1.5 million legal immigrants are allowed into the U.S. each year, with another estimated 900,000 immigrants entering the country illegally. These immigrants need to be housed. In addition, the longer immigrants are here and become acclimated, the more their homeownership rates increase to approach that

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As long as consumer spending continues to grow, the economy is likely to avoid a recession.

The U.S. economy is slowing

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of the rest of the population. As a result, the pool of potential home buyers is continuing to grow.

However, despite some favorable longer term fundamentals, housing is likely to remain soft at least over the first part of this year. The problem for this sector is the amount of excess inventory that needs to be absorbed before housing can start to recover. Until home sales pick up and inventories are reduced, housing will probably continue to be a drag on growth.

The Fed is likely to continue its bias toward ease

Slowing economic conditions, continued weakness in housing and ongoing credit market concerns mean that the Fed is likely to have a bias toward ease. Although the increase in headline inflation is probably discomfiting to the central bank, we expect it to continue to focus on the core inflation rate, which is running around 2%. The current Fed Funds rate of 4.25% is also well above market rates and inflation, giving the Fed plenty of room to lower rates.

The Fed's main focus will likely be on easing credit market pressures and averting systemic risk as the credit markets remain fragile. However, a number of positive developments have led to an improvement in credit conditions. Banks, brokerage houses and other financial entities have seen large infusions of capital from both foreign and domestic sources, as investors purchase cheap assets and financial entities raise capital. The Fed has initiated a bi-weekly Term Auction Facility that allows banks to borrow anonymously from the central bank, thus avoiding the stigma that comes from going to the discount window for loans. As a result, there has been a sharp drop in the London Interbank Rate and liquidity is flowing more smoothly. Finally, at the initiative of the Treasury Department, bankers, regulators and investors formed a Hope Now Alliance that has developed a new plan to freeze interest rates on some subprime loans. Given the large volume of adjustable rate mortgage resets next year, this should help reduce foreclosures.

Outside a booming Asia, global growth is in a slowing trend

Global economic growth is in a slowing trend, with the exception of strong growth in Asia and in other emerging markets. Europe is slowing but is unlikely to slip into recession. Although some indictors are starting to look more encouraging, Japan is still struggling.

Eurozone growth continues to slow

Eurozone growth has slowed to a 2.5% pace, down from 3.5% a year ago. Domestic consumption continues to grow slowly, with German household consumption relatively flat over the last year and France growing at 2.2%. Europe has been a major beneficiary of the global economic boom. Despite a strong euro, Eurozone exports have held up remarkably well, boosting both industrial production and capital spending. However, given the weakness in the OECD Leading Index and in consumer and business confidence surveys, European growth is unlikely to accelerate anytime soon.

Despite the growth slowdown and some credit problems, the European Central Bank (ECB) has been reluctant to cut overnight rates due to concerns about a 3.1% headline inflation rate. Until the economy slows further or the headline rate declines, the ECB is likely to remain on the sidelines.

Japan is still struggling

Japan's economy continues to grow at a 1.5% pace and has been unable to shake deflationary pressures. Household spending was down -0.6% year over year in November. Given the weakness in employment and wages, spending is unlikely to accelerate. Housing starts have been plunging since the government imposed new building restrictions in July, falling to 27.6% below the year ago level by the end of November. Monetary growth and bank lending remain weak. In addition, several surveys indicate consumer and business confidence is falling.

On a positive note, land prices in the three major cities of Tokyo, Osaka and Nagoya rose last year by 3.8%, the first positive year since 1991. November also saw imports jump 13.2% year over year. Typically, growing imports reflect a strengthening in domestic demand. However, we'll have to see if a trend develops from this one-month number and await confirmation from other domestic indicators.

Asia continues to boom

China, which grew at a third quarter rate of 11.5% year over year, is the new driver of Asian growth. The other countries in this region export almost five times as much to China as to Europe and ten times as much to China as to the U.S. China's growth is no longer solely dependent on the U.S. consumer. With net exports accounting for 20% of GDP, even a significant decline in exports would likely leave China with extremely strong growth due to a robust domestic economy. Per capita income of urban households has more than doubled since 2000, more people are moving to the cities, and infrastructure spending should continue to grow rapidly as China's industrial and service sectors advance.

China is the new driver of Asian growth.

India is also in the midst of its own economic revolution. At the end of the third quarter, growth in India was up 8.9% year over year. Industrial production and capital expenditures accelerated in October, growing 11.8% and 20.5% year to year, respectively. Indian exports also rose 35.7%, their fastest growth rate in fifteen months. Given that the rupee is at a nine-year high versus the dollar, the improvement in trade is encouraging. After raising rates over the last three years, the Reserve Bank of India (RBI) has kept the overnight rate steady at 7.75% since March. The RBI is unlikely to raise rates further, since urban inflation has declined from 7.8% earlier in the year to 5.5% in October.

Investors continued their flight to quality in the fourth quarter

The U.S. bond market, as measured by the Merrill Lynch Corporate, Government and Mortgage Master index, returned a healthy 3.1% for the fourth quarter of 2007.

In a credit crisis-induced flight to quality, bonds with no credit risk significantly outperformed those that relied on earnings (corporate debt) or public finance revenues (municipal debt). U.S. government bonds benefited from efforts to inject liquidity into the seizing financial markets. The Merrill Lynch U.S. Treasury Master index, for example, rose 4.0% for the quarter. Investors were not so kind to other sectors of the bond market. According to the Merrill Lynch U.S. Corporate Master index, investment grade corporate debt returned just 1.9%. And high-yield debt (based on the Merrill Lynch U.S. High-Yield, Cash Pay index) fell -1.1% for the period, led down by the lowest grade issuers.

Municipal bonds face insurance concerns

Municipal bonds are potentially one of the more troubling areas of the fixed income market today. The problem here isn't with the borrowers, who have yet to feel any dramatic impact on their revenues from the slowdown in the economy. Instead, the problem is that almost 50% of the municipal bonds issued nationally achieve their coveted AAA-rating based on insurance purchased from an independent party rather than through the financial strength of the borrower. In California, that number is even higher, since the state's relatively low general obligation rating (at A+, it is the second lowest in the nation) heightens investor desire for insurance protection. Unfortunately, AMBAC, FGIC, MBIA and the other firms that offer this municipal bond insurance also insure other types of debt, including asset-backed pools impaired by the subprime crisis. Losses from the latter part of their businesses are leading some to question these insurers' credit worthiness and their ability to back up the insurance policies that underwrite the AAA ratings on municipal bonds.

It is difficult to assess how risky this situation really is. At the end of last year, Warren Buffet stepped into this breach by signaling his intention to start a new municipal bond insurer. Investors in California municipal debt can also take comfort in the fact that, because even uninsured California debt is highly in demand, it trades at a lower yield (e.g. a higher price) than would be indicated by the state's A+ rating. For example, as of this writing, a seven-year insured municipal bond trades at a yield of approximately 3.43%. California only needs to offer investors 9 basis points (0.09%) more to sell that bond without insurance. Said another way, if the value of the insurance wrapper in this example goes to zero, the likely price impact on the bond would be only about 0.5%.

Foreign Exchange

The fourth quarter capped off another year of general U.S. dollar weakness around the world. Although the greenback gained 2.8% versus the British pound during this three-month period, it lost -0.5%, -2.4% and -2.7%, respectively, against the Canadian dollar, euro and yen. For the 2007 calendar year, the dollar's losses against some of the major currencies ranged from just -1% versus the British pound to -11% versus the euro and -18% versus the Canadian dollar.

So long as the U.S. is the source of much of the world's financial anxiety, it is difficult to forecast a strong rebound in the dollar's fortunes. Growth and interest rate differentials continue to favor foreign currencies, particularly since further economic weakness is likely to push the Fed to increase liquidity, putting renewed downward pressure on U.S. short-term interest rates.

U.S. stocks gained ground in 2007

Given investors' concerns about the impact of the housing slowdown and the credit crunch on the U.S. economy, it is not surprising that most major domestic stock market indices ended the fourth quarter on a negative note.

The S&P 500 declined -3.3% for the three months, while the Dow Jones Industrial Average was off -3.9%. Much more surprising was the U.S. stock market's performance for the 2007 calendar year.

If you were handed all of the newspapers over the past six months and told to make an educated guess on stock market performance for the full year, you might have said that it was a bad year—perhaps even a negative one. With daily news of the subprime crisis, the ensuing credit crunch, home foreclosures, sky-rocketing oil prices and the weakening consumer, could stock market investors have really made money in 2007? The answer is, yes, they actually did.

U.S. stocks posted positive returns last year

The S&P 500 advanced 5.5% and the Dow Jones Industrial Average returned 8.9% in 2007. With the exception of value stocks, all major stock market categories posted positive results for the year. Growth emerged as the clear winner across the market capitalization spectrum. The Dow Jones Wilshire U.S. Large Cap index advanced 11.0%, while the corresponding Dow Jones Wilshire Mid Cap and Small Cap growth indices returned 10.7% and 8.1%, respectively. Since humans tend to worry and focus on the bad news, it's not surprising that the headlines paid little attention to what went right last year.

Of the ten economic sectors in the S&P 500 index, eight posted positive returns in 2007. Energy, basic materials and utility stocks performed particularly well over the year. The information technology sector came in fourth place, returning 16.3%. Positive fundamentals on the earnings and revenue side, as well as moderate valuations, provided a much needed boost for technology stocks this year.

The two sectors that posted negative returns should come as no surprise. Both the consumer discretionary and the financials sectors made a very poor showing in 2007, returning -13.6% and -19.0%, respectively.

The outlook for 2008

There is no doubt that 2008 has gotten off to a challenging start. Earnings expectations generally correlate quite well with stock price performance. Earnings estimates have been significantly revised downward for financial stocks, with the most recent downward revision for fourth quarter 2007 earnings being 45% lower than previous earnings estimates. The consumer discretionary sector has also seen downward revisions over the past six weeks. The key question is whether earnings have been revised downward enough. The potential for divergent outcomes is high. However it is possible that a simple avoidance of recession and a stabilization of the housing market might be enough to let investors heave a big sigh of relief, paving the way for a solid 2008.

Growth emerged as the clear winner across the market capitalization spectrum.

Emerging markets significantly outperformed developed markets

In the fourth quarter of 2007, international stocks struggled to climb a wall of worry built on the foundation of the U.S. housing slump, subprime mortgage defaults and the resulting credit crunch.

In several well publicized instances, a number of international banks and institutional investors were forced to write down financial assets due to their U.S. mortgage exposure. When all the dust had settled, international stocks as measured by the MSCI All Country World (ex-U.S.) index (net dividends), were off -0.7% in U.S. dollar terms. Emerging markets generally out-performed the developing markets. The MSCI Emerging Markets index, for example, rose 3.7%, while the MSCI EAFE index of developed market countries returned -1.7% (gross dividends, U.S.$).

The same relative return trends can be seen for the 2007 calendar year, when the MSCI All Country World (ex-U.S.) index (net dividends, U.S. $) advanced 16.7%. The stock markets of the emerging world significantly outperformed the stock markets of the developed world, 39.8% to 11.6%, based on the MSCI Emerging Markets and EAFE indices (gross dividends, U.S. $).

The credit crisis has not hurt the emerging market economies

The disparity in returns is a useful lens through which to view the impact of the current credit crunch. First, credit risks are emanating from the developed world, where the market impact has been primarily felt thus far. The mortgage assets that are being written down are concentrated on the balance sheets of U.S. financial institutions. Other large developed market global banks appear to have lesser exposures, and, so far, we have not seen evidence of much impact in the emerging markets. In fact, turning much of post-World War II history on its head, the emerging world has been financially bailing out the developed countries. Toward the end of the quarter, Merrill Lynch, Morgan Stanley and Citigroup received capital injections from the sovereign funds of Singapore, China and Abu Dhabi. After years of supplying the goods and raw materials Americans have desired, these nations now have the capital to invest back in U.S. assets.

Second, on a more fundamental level, many emerging countries have developed greater economic independence from the U.S. For example, Southeast Asia is increasingly self-sustaining in that much of what the region produces is utilized within Asia. As a result, this region doesn't require the same level of U.S. demand to generate long-term growth. A similar tale can be told of Eastern Europe. While a complete decoupling of global growth is unlikely, it would not be shocking to see emerging growth "wag" that of a more tepid developed world in 2008.

Return differences highlight importance of country allocations

The breadth of country returns in 2007 showed up statistically as well. Based on our analysis of 48 MSCI country indices (price change only, U.S. $ terms), 2007 witnessed the greatest diversity in returns among the major international stock markets in this decade. While the median country returned 22.9% last year, the top 25th percentile country returned 38.0% and the 75th percentile country returned just 5.4%. This spread of 32.6% is relatively large on an historical basis and provides continuing evidence of the inherent opportunities in strategies focused on country allocation.

Real estate returns are likely to move sideways or down for the next few quarters

The usual 20-year cycle of increasingly easy money in real estate finally came to an end in 2007.

Although the credit crisis began as a subprime mortgage problem in the housing market, doubts about credit quality and credit ratings soon spread to the publicly traded CMBS and CDO conduit-loan markets. (Commercial mortgage-backed securities are packages of commercial property mortgages, while collateralized debt obligations are bundles of even riskier property debt such as mezzanine loans and bridge loans.) In the reselling of these loans to other investors, the original lender didn't worry as much about being left holding the bag. In 2003, only 20% of conduit loans were issued as interest-only, or interest-only for some initial period; by 2007, over 80% of conduit loans were of such quality (with a similar reduction in underwriting standards). The flood of easy money helped fuel the rise in property prices, as measured by the decline in property capitalization ("cap") rates.

The credit crunch is having an impact on the commercial real estate market

Thanks to the credit crunch, mortgage money continues to be much less available and more expensive than it was prior to the disappearance of liquidity in the mortgage securities market. Now that so much potential buying power has left the market, cap rates have begun to inch back up. According to Real Capital Analytics, which collects data on most property transactions above $5 million, by November, cap rates had risen an average of 30 basis points (0.3%), with the increases ranging from 20 to 50 basis points (0.2% to 0.5%) depending on property type. That means that, if a building's net income remained flat over the past year and it traded at a 6.5% yield at the peak of the market, it now might trade at a 6.8% cap rate, for a price reduction of -4.4%.

However, we probably haven't yet seen the full effect of the credit crunch. Many properties have fallen out of escrow or been pulled off the market because sellers could not get the price they wanted. Trading volume is way down, and the properties that do trade tend to be the best quality properties in the best metropolitan areas. In an extreme example, of the $6.5 billion of office buildings that traded in November, fully $4.5 billion were located in Manhattan! We really won't know how much the cap rates on an average property in an average location have risen (prices have fallen), until sellers feel the need to get back in the market and take what they can.

The impact is unlikely to be severe

The NCREIF National Property index will probably move sideways, or down slowly, for the next few quarters, given the sluggishness of the appraisal process in reacting to market changes. That does not mean investors should panic. Eventually, the markets will find a new balance between buyers and sellers, and the full re-pricing will be evident. However, our analysis suggests such re-pricing is unlikely to be anything like the drops in the early 1990's because:

- Commercial properties are generally operating well, producing solid net incomes with no observable rise in defaults and, therefore, little financial pressure to sell.
- Many properties are actually experiencing rising incomes, which should serve to at least partly offset the impact of rising cap rates.
- With ten-year Treasury bonds yielding less than 4%, the historic risk premium for an investment property of 200 to 300 basis points (2.0% to 3.0%) suggests that cap rates should stay in the 6% to 7% range.
- There is little threat of dramatic overbuilding and resulting vacancy problems.

At this point, we believe the best strategy is to hold on to the properties you have, wait patiently for more sellers to return to the market and then use cash reserves or borrowing power to take advantage of what should be better investment opportunities in the months ahead.

Such re-pricing is unlikely to be anything like the drops of the early 1990's.

We remain overweight in global equities

Despite the increased volatility in the equity markets late in the second half of 2007, U.S. and international stocks posted another year of solid gains.

The MSCI All Country World (ex-U.S.) index (net dividends, U.S. $) rose 16.7%, the Dow Jones Industrial Average increased 8.9%, and the S&P 500 advanced 5.5% for the year. On balance, our overweight allocation to equities was a positive. Despite all the volatility, we remain generally optimistic about the equity markets over the next year.

Global Bonds: Underweight

Investment grade bonds, led by U.S. Treasuries, continued to perform well in the fourth quarter as investors gravitated toward perceived safer bets. Lower grade bonds, on the other hand, struggled as yields rose and credit spreads widened. The ten-year U.S. Treasury bond yield dropped from 4.5% to 4.0% during the quarter. The last six months would have been a good time to have had more money in bonds, but we find the valuations not very compelling. When credit concerns settle down, bond yields could rise sharply as the safe haven premium evaporates. Significant returns from bonds are unlikely outside of a recession. We continue to hold some bonds in portfolios for diversification purposes and to help protect portfolios in negative economic scenarios.

U.S. Stocks: Overweight

Stock valuations remain very attractive. With forward P/E's below 15 times earnings, core inflation around 2% and bond yields extremely low, stocks make a compelling investment alternative. If we are correct in our forecast that growth will slow, earnings should continue to surprise to the upside and act as a catalyst for value recognition. If there is a mild recession, we expect limited downside from here and returns over the next twelve months to be higher. However, since the long-term trend of the market seems to be reversing, we will take action, if necessary, in accordance with our investment disciplines.

Since the long-term trend of the market seems to be reversing, we will take action, if necessary, in accordance with our investment disciplines.

International Stocks: Overweight

We continue to view international stocks as an attractive bet on sustained global economic growth. This is particularly true for emerging markets. Relative to underlying economic growth, inflation and interest rates, international stocks are as attractive as U.S. stocks. The persistent weakness in the dollar has also helped international returns. Even if the dollar were to stabilize, we think there is enough return in the equity markets to more than offset any erosion from a stronger dollar. As with the U.S market, since the long-term trend of the market appears to be turning down, we will take any necessary action in accordance with our investment disciplines, while still remaining overweight in this asset class.

Real Estate: Neutral*

Commercial real estate activity has slowed, with the number of transactions falling sharply over the last year. While the best returns from real estate are probably behind us, we believe it continues to provide important risk reducing diversification benefits. Real estate looks particularly attractive relative to cash and U.S. Treasury bonds. In addition, active management provides the opportunity for adding value at the property level.

Alternative Assets: Neutral*

The recent financial market turmoil reinforces our belief in using alternative assets to offset the risk inherent in equity only portfolios. With fixed income yields so low, alternative investments have the potential to help reduce short-term volatility and/or enhance long-term returns.

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

U.S. INTEREST RATES	3/31/2007	6/30/2007	9/30/2007	12/31/2007
Cash Equivalents				
90-Day Treasury Bills	5.04%	4.81%	3.81%	3.25%
Federal Funds Target	5.25%	5.25%	4.75%	4.25%
Bank Prime Rate	8.25%	8.25%	7.75%	7.25%
Money Market Funds	5.10%	5.14%	5.06%	4.59%
Bonds				
30-Year U.S. Treasury	4.85%	5.13%	4.84%	4.45%
20-Year AA Municipal	4.05%	4.40%	4.28%	4.38%

Source: Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 12/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	5.01%	10.28%	10.28%
Merrill Lynch 7-10 year Agency Index	4.14%	8.92%	8.92%
Merrill Lynch 5-10 year Corporate Index	1.99%	4.40%	4.40%
Lehman Bros. Municipal Bond Index	1.37%	3.36%	3.36%
International Bonds			
Citigroup non-U.S.$ World Government Bond Index, fully hedged	1.94%	4.88%	4.88%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 12/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-3.91%	8.87%	8.87%
S&P 500	-3.33%	5.49%	5.49%
NASDAQ 100	-0.14%	19.26%	19.26%
S&P SmallCap 600/CItigroup Value	-6.87%	-5.19%	-5.19%
International Stocks			
MSCI Japan, net dividends	-6.08%	-4.23%	-4.23%
MSCI Europe (includes UK), net dividends	-0.46%	13.86%	13.86%
MSCI EAFE (Europe, Australia, Far East), net dividends	-1.75%	11.17%	11.17%

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

REAL ESTATE TOTAL RETURNS (US$) THROUGH 12/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF Property Index*	3.56%	16.23%	16.23%

*Return for last quarter is an estimate.

Source: The National Council of Real Estate Investment Fiduciaries

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About *the 9:05*

Since 1978, we've held a weekly companywide 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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