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A Quarterly Review of Economic and Market Developments

1ST QUARTER 2007

BAILARD INTERVIEW

A Primer on Hedge Funds

Hedge funds have received quite a bit of publicity in recent years. In this interview, we ask Bailard's Senior Vice President of Quantitative Research, Dana D. Hobson, about these alternative investments.

Dana D. Hobson, PhD, CFA
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Dana, the very name "hedge fund" conjures up images of risk, leverage and opaque, unregulated investments. Can you tell us, what is a hedge fund?

A hedge fund, like a mutual fund, is simply a legal structure for making investments. Mutual funds are public offerings and are heavily regulated. Hedge funds are private offerings and are very lightly regulated. As a result, the manager of a hedge fund is much freer to make innovations in terms of the amount of leverage, the types of investment instruments and the investment strategies employed in an attempt to achieve specific investment goals. The character of an individual hedge fund, like that of a mutual fund, depends entirely on its specific investment objectives and management style. Most hedge funds invest in stocks, some invest in bonds, and some invest in commodities. Some use derivatives like futures and options. Some borrow money to increase leverage, in effect increasing the size of their bets.

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A primer on hedge funds

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Some are long only, just buying securities like stocks, for example. Other hedge funds also short securities (i.e. sell securities they don't own), living up to their original persona by "hedging" their long investments in order to reduce overall market exposure. While some mutual funds can also pursue long/short hedging strategies, they are subject to more restrictions than their hedge fund counterparts.

So if hedge funds have the ability to be flexible in terms of how and in what they invest, does that make them more risky than mutual funds?

Well, that really depends on the specific type of investments the hedge fund makes, the amount of leverage it uses and the underlying risk of the strategies it employs. Riskier hedge funds tend to make highly concentrated, highly leveraged bets. These bets might be cast through the use of concentrated long/short strategies that amplify rather than hedge certain outcomes by making the same bet twice (once long and once short). Bets can also be made through the use of commodities or futures contracts, which are inherently more leveraged than stocks or bonds and hence potentially more risky. Also the use of leverage allows the purchase of securities in amounts many times greater than their underlying assets, amplifying the effect of any positive or negative price movements. Leverage of these types is the primary driver of hedge fund risk. High risk, speculative strategies can yield very good returns if the bets play out, but can blow up if they do not. This is what happened to Long Term Capital Management when it famously collapsed in 1998, due in part to the Russian crisis. More recently, the well publicized implosion of Amaranth in 2006 resulted from a concentrated bet on the wrong side of natural gas prices, among other things. Hedge funds employing these strategies have the potential to be significantly riskier than mutual funds.

On the other hand, some hedge funds try to "hedge" their bets by offsetting their long market exposures with corresponding short investments. In the case of stocks, buying one basket of stocks and shorting another can potentially be a very effective way of minimizing risk. A hedge fund that employs a conservative market neutral strategy, one that shorts as many stocks as it buys, can potentially have a lot less risk than a long only stock mutual fund that invests, for example, in a limited number of small, financially unstable companies. So, in order to appreciate what level of risk a hedge fund or a mutual fund has, we have to know more about what the fund does and the investment strategies it employs.

Given there are so many types of hedge fund strategies, what role be, if any, should they play in a diversified, multi-asset class portfolio?

Bailard believes that conservative, long/short investment strategies can play a very important role in the pursuit of what we call the "perfect portfolio" (that is, the asset mix more likely to achieve good long-term returns while controlling overall risk). Since such long/short strategies are designed to be uncorrelated with other asset classes, they can temper the overall volatility of an investor's portfolio. A properly designed long/short investment strategy offers the possibility of delivering steady returns even during a bear market. Conservative long/short investments should work alongside other low volatility assets, such as real estate and cash, to form a stable base in an investor's portfolio. This can allow investors to make more aggressive investments (in international stocks and specialized asset sectors, for example) while maintaining a lower volatility portfolio than would otherwise be the case.

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A primer on hedge funds

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I've heard that one way qualified investors are investing in hedge funds is through a Hedge Fund of Funds. I've also heard about multi-strategy hedge funds. What should I know about these types of investments?

A Hedge Fund of Funds (FoF) is a fund that invests in a variety of hedge funds, thereby giving investors access to what is usually a diversified collection of hedge funds' strategies within one instrument. This is accomplished by distributing the risk and return opportunities across a number of underlying mangers. In many cases, this is the only way an individual investor can gain access to multiple hedge fund strategies, as it would be unfeasible to meet the high investment minimums of numerous individual hedge funds.

FoFs have also been very popular among institutions that also don't want to make direct investments in hedge funds, fearing they don't have the expertise to select, monitor and do business with a number of hedge fund firms. The downside is that a FoF adds another layer of fees to the fees of the underlying hedge funds. This can be a significant drag on net performance.

Multi-strategy funds, on the other hand, offer investors diversification among a variety of strategies within a single fund managed by one manager. Multi-strategy funds tend to have lower fees as they avoid the additional fee layer of most FoFs.

Speaking of fees, I've heard hedge fund fees can be quite high. What type of fees do hedge funds typically charge and are they worth it?

Most hedge funds charge both a management fee and an incentive fee. The management fee is usually a percentage of the assets under management, while the incentive fee is often a percentage of the net profits. Typical management fees range from 1% to 2% and incentive fees are generally around 20%, though highly demanded managers may charge more. Hedge Fund of Funds typically charge a 1% management fee and a 10% incentive fee on top of the fees levied by the underlying funds in which they invest. These fees certainly make for a higher hurdle to overcome in terms of delivering desirable net returns, but they are not without merit. A successful hedge fund will deliver investors positive, uncorrelated returns typically with a high degree of *alpha*. Simply stated, alpha is the extra return awarded by good individual security selection beyond what would be achieved given the systematic risks of the investments. Achieving alpha is what most hedge fund managers are after and the reason that many investors are wiling to pay more to invest in hedge funds. The higher cost of hedge funds also reflects the added operational costs, as well as the historical relationship between investors and hedge fund managers who are motivated by the underlying incentive fee.

What else should investors know about hedge funds?

Like other private investments, hedge funds are not suitable for all investors. They are available only to investors who meet certain accreditation and qualification standards. My compliance officer would also want me to tell you that: hedge funds can be speculative and investors can lose all or a substantial part of an investment; hedge funds typically have limited liquidity and complex tax considerations; they are subject to less regulation and potentially have higher fees than more traditional investment alternatives; and a hedge fund's performance based fee may be an incentive for its adviser to engage in riskier transactions than they might otherwise. As is always the case, investors should carefully review any offering documents of an investment (particularly any discussion of investment risks) before deciding to invest.

Our base case scenario calls for trend economic growth of around 3%

In March, we completed a multi-scenario economic and market review, concluding that the outlook remains positive for both the economy and the financial markets.

Despite growing concerns about subprime mortgages, housing weakness, the potential for a housing-driven recession and rising oil prices, our base case scenario calls for trend economic growth of around 3%, with inflation between 2% and 3%. If we are wrong in this forecast, we think it is most likely that growth will be stronger than expected. Our third scenario holds out the possibility of recession, but we believe talk of such a slump is premature.

According to the final GDP report, growth in the fourth quarter of 2006 was revised up from 2.2% to 2.5%. Year-over-year growth was also revised up slightly to 3.1%. We expect the same growth rate this year, with above trend growth in the second half following below trend growth in the first half. Real interest rates (ten-year bond yields minus inflation) are low around the world. Although equities and commodities stumbled during the first quarter and credit quality yield spreads widened a bit, many equity markets have moved out to new highs and credit spreads are still very narrow. So the message from the markets appears to be that the expansion is still intact. The economy has hit a bit of a soft patch (mostly due to housing), but we believe that investors should look across the valley to better growth in the second half of 2007.

Consumer and corporate sectors still strong

The economy should benefit from a healthy consumer sector. As long as jobs are being created and incomes are growing, consumers should continue to spend. Employment growth is running at a strong 2.0% trend rate, with 2.6 million jobs created over the year ending February 28, 2007. Personal income is growing around a 6% trend rate and real wages are growing at 3%. The consumer balance sheet also looks very healthy. In 2006, household net worth (total assets minus total liabilities) rose $3.8 trillion to $55.6 trillion. Financial net worth, which excludes homes from assets but includes mortgages in liabilities, grew $2.2 trillion to $28.8 trillion.

The corporate sector also looks healthy, with low levels of debt and lots of liquidity. Earnings and cash flow continue to surprise to the upside, giving firms the ability to fund capital expenditures. Since capacity utilization rates are high and businesses need to remain globally competitive, corporations are likely to continue to spend heavily on capital investments. Capital good manufacturers should also benefit from strong global growth.

The case for even stronger growth rests on the potential for a housing recovery later in the year. After several years of subpar activity, pent-up demand for housing is increasing. If interest rates remain stable and sales pick up, the housing inventory should be reduced and home-builders should begin building new homes. Even if housing were only to stabilize, an end to the housing slowdown could help boost the economy. In the fourth quarter, residential investment reduced growth by over 1.0%. Removing this drag could lead to above trend growth.

In our view, geopolitical tensions pose the greatest risk to the economy. We are also concerned about the possibility of fiscal policy mistakes, particularly ahead of the 2008 election. While the recent imposition of duties on coated paper imported from China was an attempt to level the trading playing field, such targeted tariffs run the risk of sparking retaliation or broad based protectionist measures. There is also a risk that counterproductive regulations may be imposed on mortgage bankers in a response to subprime mortgage problems. Finally, concerns about the expiration of the 2003 tax cuts could start to loom large ahead of the elections. Fortunately, we don't believe any of these forces will be enough to tip the economy into recession over the next year.

The international outlook is still positive

With the exception of Japan, economic growth overseas remains robust.

China and India continued to grow at a rapid pace

India's GDP did slow in the fourth quarter of 2006, but only to an 8.6% year-over-year growth rate. Most of the weakness was due to softer farm production, which tends to be driven by seasonal factors. Growth is likely to remain robust going forward.

Despite efforts to slow growth, China continues to grow at a 10% per year rate. In March, the Peoples Bank of China (PBOC) increased the lending rate by 27 basis points (0.27%) to 6.39%, its highest level in eight years. This is the third rate hike by the PBOC in the last eleven months. The government's attempt to slow credit growth has not yet had an impact on bank lending or liquidity. Banks are very liquid after raising $100 billion of capital (the equivalent of over $1 trillion in lending power) last year.

Retail sales were up 14.7% year over year in February. Driven by export growth of 51.6%, industrial production has risen 18.5%. Despite this strong growth, inflation has been a lower than expected 2.7%. The PBOC is likely to continue leaning against growth to keep inflation contained.

Japan's domestic growth is fading

After rebounding strongly in the fourth quarter of last year, the Japanese economy has again decelerated. Fourth quarter GDP was revised higher to a 5.5% annualized rate, as the current account surplus was revised upward and capital spending rose 16.8%. Healthy exports and capital spending should keep the economy growing, but it is discouraging to see domestic demand flounder. Retail sales declined in January and February, and wage growth continued to fall. Despite a relatively high jobs/applicant ratio and a low unemployment rate, employment growth remains soft. Industrial production is only up 2.5% year over year, and most of this production is going to exports. Monetary growth and bank lending have also weakened, while inflation has turned negative again. All this suggests that the Bank of Japan will move slowly in tightening monetary policy.

Eurozone growth remains solid

As expected, German retail activity slowed in January and February due to the new value-added tax. Outside of Germany, retail sales were better than expected. Industrial production was also stronger than anticipated due to higher export demand. As a result, in March, business and investor confidence rose in Germany, France and the Eurozone. With inflation below 2%, the European Central Bank (ECB) could stay on hold (i.e. neither lower nor increase interest rates) a bit longer. However, given our positive global economic outlook, the ECB's next move will probably be to raise interest rates.

British growth remains strong

British GDP growth in the fourth quarter was revised higher to 3.0%, and economic activity appears to have accelerated since year end. After sluggish, housing driven growth in 2005, the economy steadily improved last year and 2007 looks to be another good year. Housing has rebounded sharply, with home prices up almost 10% in March. In addition, retail sales rose by a better than expected 4.9% year over year in February, the trade deficit narrowed on stronger export growth, employment trends remain favorable, and inventories are lean. Since real interest rates are relatively low, the British economy should continue to grow at a good pace. However, the Bank of England (BOE) is starting to become concerned about excessive growth, froth returning to the housing market, rising inflationary pressures and too abundant liquidity. With inflation creeping up to 2.8% in February, we believe the BOE will have a bias toward tightening. This could lead to slower growth in the second half, particularly in the housing and export sectors, as interest rates rise and the pound strengthens.

With the exception of Japan, economic growth overseas remains robust.

A quiet quarter for U.S. bonds

The bond markets continued their blasé attitude to all things economic and financial in the first quarter. Yields have generally been range-bound now for the past four years, with long-term U.S. Treasury debt trading between 4% and 5.5% over that period.

For the first quarter of 2007, diversified U.S. taxable bond investors achieved returns of about 1.5%, as measured by the Lehman Brothers Aggregate U.S. Bond index. This exceeded municipal debt's pre-tax return of 0.8% as measured by the Lehman Brothers Municipal Bond index. Over the past year, the story is much the same: taxable debt has returned slightly more than municipal debt. Within the taxable arena, investment-grade bonds and high-yield debt have been the strongest performers. On the international bond front, the Citigroup Non-U.S. Dollar World Government Bond index (fully hedged) was up 0.9% for the quarter and 5.0% for the past year.

Increased concern over high-risk mortgages and prospects for a Fed easing led to a small U.S. bond market rally in February, before the global stock market pull back at the end of the month. However, when the equity markets quickly found their footing in early March, general risk-taking returned to the financial markets and yields rose to levels not far from where they began the quarter.

Continued competition from imported goods is likely to help the U.S. economy grow with a decreased risk of inflation. Fed policy has now been on hold for nine months and looks to remain so for the immediate future. As a result, without exogenous shocks, we believe bond investors are likely to continue to, more or less, earn their coupons.

Foreign Exchange

The U.S. dollar fell against most foreign currencies during the quarter. The declines were small—on the order of 1%—against many of the major currencies. The declines tended to be greater against some emerging market currencies. (At the extreme, the dollar fell about -3.7% versus the Brazilian real.)

Global money flows tend to go where the most generous real interest rates are. But most of the developed markets are offering real short-term rates of 2.25% to 2.5%, right in line with those of the U.S. From a longer-term structural perspective, the move by foreign central banks to diversify holdings away from dollars and into Euros and gold should continue to act against a stronger dollar.

Nevertheless, the generally one-sided sentiment among non-U.S. investors against the dollar appears overdone. It would not be surprising to see short-term rallies in the greenback even in the midst of general longer-term weakness.

Market volatility in the first quarter improves the outlook for U.S. stocks

Although most broad U.S. stock market indices finished the quarter up slightly, the path they took to get there was anything but dull.

During the first quarter of 2007, the S&P 500 rose 0.6%, the Dow Jones Industrial Average fell -0.3%, the NASDAQ 100 returned 1.0%, and the S&P 600/Citigroup Small Value index advanced 2.2%. U.S. stocks started off strongly in early January, with many market indices up between 1% and 3%, but sold off to basically flat levels toward the end of the month. February witnessed a rally in the first thee weeks of the month, with indices rising 2% to 4%, only to see the market sell off sharply in the final week. March began by continuing February's downturn, with the indices down -7% to -8% in less than two weeks. Stocks then bounced around briefly before rallying strongly into positive territory again, up 4% to 5% in a week. A final sell off of approximately 2% ended the quarter, leaving investors barely ahead of where they started the year.

The market pull backs were sparked by, among other things, subprime mortgage defaults, rising oil prices, former Federal Reserve Chairman Alan Greenspan's comments about the possibility of a recession toward the end of the year and a sharp decline in the Chinese stock market. These issues and the market volatility left investors with jangled nerves and a much less bullish outlook.

A healthy development

Ironically, we see this skepticism about the prospects for the U.S. stock market as a healthy development. Near the end of 2006, we believed that investors' excessively positive outlook was a major risk factor for the U.S. stock market. An old Wall Street adage is that stocks climb a wall of worry. This usually proves to be true because investors typically overreact to negative news. As time passes and reality shows that things weren't quite as bad as initially feared, stocks tend to move higher. Conversely, when few investors are worried, there aren't many minds to change, and stocks don't tend to do as well.

Investors' volatile journey through the first quarter shook their faith in the stock market. Measures of investor sentiment dropped from extremely bullish in December, 2006 to bearish or, at worst, neutral by the end of the first quarter. Should the economy remain healthy as we expect, there will likely be pent-up demand for equities later in the year.

The outlook for large cap vs. small cap stocks

If there is pent-up equity demand later in the year, what type of stocks are investors likely to favor? This is not an easy question to answer. Small cap stocks, particularly small value stocks, have performed very well for the past seven years, while large cap stocks, particularly large growth stocks, have lagged. Valuations, which used to greatly favor small cap stocks, have largely equalized.

Growth prospects for both types of stocks remain good, but the recent tightening of bank lending standards and dollar weakness may give a slight nod toward large cap stocks. Small companies generally have a harder time accessing credit than their larger competitors. When lending standards are strict, a small company may lack the financial flexibility available to a larger company and therefore be at somewhat of a disadvantage. A weak dollar helps companies that do a lot of business internationally. Overseas profits are generated in local currency. When those profits are exchanged for dollars, if the local currency has been strong versus the dollar, the company benefits from the favorable exchange rate. Because large companies are more likely to have international operations, they tend to benefit from a weak dollar more than most small companies.

So far in 2007, small cap stocks have continued to outperform large cap stocks. Nevertheless, equity style performance tends to be cyclical. At some point, it should be large cap's turn to outperform. Time will tell whether tightening credit access and a weak dollar are enough to turn the tide.

Should the economy remain as healthy as we expect, there will likely be pent-up demand for equities later in the year.

International stocks performed well despite some turbulence

The first quarter saw global equity investors work through a brief but scary patch of turbulence emanating from China, reassess their tolerance for risk and decide in the end that economic and corporate fundamentals justified further stock price increases. The MSCI All-Country World ex-US index (net dividends, US$ terms) returned 3.75%, extending an amazing four-year period of annualized returns just under 30%.

Causes of the turbulence

Global stocks suffered a sharp decline on February 27th in the aftermath of a -8% tumble in China's stock market, its biggest one-day decline in ten years. (The larger, better quality "H" shares traded in Hong Kong fell only -3% that day.) The market fall was supposedly instigated by governmental measures designed to crack down on speculation in mainland "A" and "B" shares. Retail investors had been borrowing against their homes in order to buy stocks, a risky practice anywhere that is against the law in China.

In addition, a strengthening yen led global investors to fear an end to the Japanese carry trade, in which funds borrowed cheaply in yen were redeployed in markets elsewhere, helping to boost international stock prices. To be successful, this strategy requires a weak yen and low borrowing rates. Fears that funds which had been supporting the global equity boom were being repatriated to Japan (as evidenced by a strengthening yen in February) added to investor anxiety. By the end of the quarter, however, these flows had abated, and the market appeared sanguine about the future prospects for the carry trade.

Fundamentals remained strong

The market reversal was driven by liquidity and sentiment, not economics. The fundamentals remained strong, and the international stock markets were resilient in gaining back most of the losses by the end of the quarter.

Chinese stocks rose 100% in 2006 before leveling off this year, but valuations are still nowhere near the levels of the Japanese or tech bubbles. The Shanghai index is trading at about 38 times earnings, and the shares listed in Hong Kong are trading at about 20 times earnings. The Chinese stock market is far less important to the world than the Chinese economy, which is likely to continue its growth.

World economic growth in 2007 (including growth in emerging markets) is likely to be in the region of 4%—another exceptionally good year. Global demand is still very strong. U.S. growth may pick up later in 2007, and developed Europe should grow a little faster than in recent years. The emerging economies are collectively in the best shape they have been in over the past twenty years, with high foreign exchange reserves, positive balances of payments, low levels of indebtedness and low inflation.

Most importantly, across global markets, the price/earnings ratio is around 16 times earnings, down from the mid-20s level of four years ago. International stocks have performed well not because of price/earnings multiple expansion but because of dramatic earnings growth. As a result, valuations are still generally reasonable.

Office buildings have finally taken the limelight

Private real estate markets have recently entered that peculiar part of the cycle where the least attractive property sector over the long run is performing the best. Office buildings and, in particular, central business district (CBD) office buildings, have finally taken the limelight.

The NCREIF National Property index (NPI) 2006 total return of 16.6% would have been only 15.4% had not CBD offices shown a 23.8% return. In contrast, since the 1978 inception of the NPI, office buildings have been the weakest performer, as the following table shows:

NCREIF NPI SECTOR ANNUAL RETURNS SINCE 1978*

Apartments	10.0%
Industrial	10.5%
Retail	10.4%
Office	9.3%

*All data through December 31, 2006.
Source: NCREIF

Historic volatility in the office sector

Over the past ten years, offices have produced returns similar to the other major property types, but with much more volatility. The office sector has historically had very volatile vacancy/occupancy cycles, and, therefore, volatile rent and income cycles. The following table lists the annual return divided by the volatility of return (standard deviation) for the four major property types for the ten years through December 31, 2006:

NCREIF NPI SECTOR RETURNS/RISK, TEN YEARS ENDED DECEMBER 31, 2006

Apartments	3.44%
Industrial	3.10%
Retail	2.43%
Office	2.05%

Source: NCREIF

With 37% of the value of the NPI, office buildings represent a major portion of a real estate portfolio for anyone wishing to approximate (or benchmark to) the NPI. The return impact of CBDs in 2006 was particularly remarkable since these properties only comprise 14.5% of the NPI. Any portfolio without this representation had a difficult time keeping pace with this benchmark. Also, since the average size of the 252 CBD buildings in the NPI index is $142 million, any diversified portfolio of less than $1 to $2 billion in assets would not likely have any representation in these properties. Prudent diversification generally precludes having any one property represent more than 5% to 10% of a portfolio.

Looking forward

Over the next one to two years, as long as job growth continues to fill up vacancies, we are likely to see a continuation of office properties leading the performance parade. Those who have taken the risk to own office buildings should do well. Those who have underweighted offices as a strategic measure to reduce risk will likely have to bide their time. Over the long run, all property returns have historically tended to converge, but the volatility differences have remained.

As long as job growth continues to fill up vacancies, we are likely to see a continuation of office properties leading the performance parade.

Back to an overweight in U.S. stocks

We moved to a slight overweighting in U.S. stocks as investor sentiment swung from extremely optimistic to pessimistic.

In February, we went back to a slight overweighting in U.S stocks and moved to a more overweight position in international stocks. We remain underweight in bonds.

Global Bonds: Underweight

As the global equity markets took a tumble in February, investors moved to the relative safety of bonds. Ten-year U.S. Treasury yields fell to 4.5%. Below 5%, yields are extremely unattractive relative to inflation at 2.5% or stocks with P/E ratios below 15 times earnings. We believe fair value is closer to 5.5%. However, with the economy slowing and the Fed on hold, there shouldn't be too much upward pressure on yields. The demand for bonds is still strong due to: 1) a healthy foreign appetite for U.S. assets; 2) demand from insurance companies, pension plans and individual retirement savings; and 3) corporations' excess cash balances. At the same time, supply is being constrained by strong corporate cash flows and a faster than expected decline in the budget deficit, which is reducing the supply of Treasury bonds coming to market. We still believe bonds have diversification merits. However, other than bonds having the "insurance-like" characteristic of tending to go up when most assets are going down, we see better opportunity elsewhere.

U.S. Stocks: Overweight

Late last year, we went to a more defensive posture, reducing our recommended U.S. stock allocation to a neutral weight after being overweight for almost four years. Our decision then was not fundamentally driven: stocks were not overvalued nor had our economic outlook turned negative. We merely thought stocks had risen too far too fast and were becoming increasingly vulnerable to unexpected bad news. In February, that bad news hit. Chinese stocks took a tumble; Alan Greenspan commented on the possibility of a recession later this year; the yen strengthened, triggering a covering of the yen carry trade; and problems with subprime loans hit the headlines. As U.S. stocks declined, we moved to a slight overweighting in U.S. stocks as investor sentiment swung from extremely optimistic to pessimistic. Stocks appear cheap at 15 times earnings. Given our optimistic economic outlook, we believe stocks will likely trend higher over the next twelve months.

International Stocks: Overweight

International stocks fell along with U.S. stocks during the first quarter of 2007. We used that market decline as an opportunity to further increase our recommended overweighting in international stocks. We believe international stocks are undervalued given the current economic and inflation environment. U.S. investors in international stocks are also continuing to benefit from dollar weakness. Finally, we believe international stocks provide diversification benefits for the overall portfolio.

Real Estate: Neutral*

Real estate continues to provide attractive returns relative to other assets. Although real estate cap rates have declined, they remain above yields for cash equivalents and bonds. In addition, the operating environment is still constructive, with higher occupancy rates and rising rents. Higher net operating income is helping to boost returns. Outside of a recession, we would expect real estate returns to remain competitive, albeit not as robust as during the days of falling cap rates. Given a longer term investment horizon, real estate returns tend to be less volatile, allowing this asset class to act as an important diversifier in reducing the volatility of the entire portfolio.

Alternative Investments: Neutral*

With bond and cash yields still relatively low, we continue to search for other diversifying opportunities to offset the risk inherent in equity only portfolios.

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

U.S. INTEREST RATES	6/30/2006	9/30/2006	12/31/2006	3/31/2007
Cash Equivalents				
90-Day Treasury Bills	4.99%	4.88%	5.02%	5.04%
Federal Funds Target	5.25%	5.25%	5.25%	5.25%
Bank Prime Rate	8.25%	8.25%	8.25%	8.25%
Money Market Funds	4.93%	5.14%	5.11%	5.10%
Bonds				
30-Year U.S. Treasury	5.19%	4.76%	4.81%	4.85%
20-Year AA Municipal	4.66%	4.12%	4.04%	4.05%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 3/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	1.62%	1.62%	6.47%
Merrill Lynch 7-10 year Agency Index	1.47%	1.47%	6.88%
Merrill Lynch 5-10 year Corporate Index	1.82%	1.82%	7.50%
Lehman Bros. Municipal Bond Index	0.81%	0.81%	5.43%
International Bonds			
Citigroup non-U.S.$ World Government Bond Index, fully hedged	0.92%	0.92%	5.02%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 3/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-0.32%	-0.32%	13.82%
S&P 500	0.64%	0.64%	11.82%
NASDAQ 100	1.01%	1.01%	4.55%
S&P/Barra 600 Small Cap Value	2.17%	2.17%	6.97%
International Stocks			
MSCI Japan, net dividends	3.52%	3.52%	3.00%
MSCI Europe (includes UK), net dividends	3.86%	3.86%	25.38%
MSCI EAFE (Europe, Australia, Far East), net dividends	4.08%	4.08%	20.20%

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

REAL ESTATE TOTAL RETURNS (US$) THROUGH 3/31/2007	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF Property Index*	4.51%	4.51%	17.59%

*Return for latest quarter is an estimate.

Source: The National Council of Real Estate Investment Fiduciaries

Past performance is no indication of future results.

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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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