

BAILARD INTERVIEW

Outlook for International Stocks

Tony Craddock, Bailard's Senior Vice President for International Equity Research, discusses the prospects for international equities in the wake of U.S. economic turmoil.

What effect do you see a U.S. economic slowdown having on the overseas stock markets?



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America's economic slowdown has already had a dramatic impact upon the overseas markets, which seem to be pricing in at least a mild recession right now. At the start of the year, most international equity markets dropped in tandem with our stock market in reaction to problems originating in the U.S. Over the first quarter of 2008, in fact, stock market declines overseas in local currency terms were more severe than the losses here at home. International stocks as measured by the MSCI EAFE index (gross dividends, local currency terms) dropped -14.9% as the S&P 500 fell -9.4%. Only the weak dollar held the MSCI EAFE index's losses to -8.9% in U.S. dollar terms. In addition, all but one of the 21 country markets in the MSCI EAFE index (U.S.\$) declined more than the U.S. market during the first quarter.

Is it just the financial markets that are threatened by contagion, or is real economic activity also in danger?

Setting aside the correlated market declines, I see two primary (and related) threats to

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international economic growth at this time. One is a deepening global credit crunch, where the spectre of further asset write-downs and general uncertainty about the health of counterparties' balance sheets make banks unwilling to lend to each other, to corporations operating in the real economy or even to consumers wanting to spend. The other concern is the strength of U.S. demand for other countries' exports.

Are these concerns justified?

A credit crunch is fundamentally a crisis of confidence – and it seems that the U.S. Federal Reserve Board (Fed) has acted aggressively and creatively enough to restore confidence and some stability to the financial markets. The Fed has slashed short-term interest rates and offered expanded lending facilities to banks and even brokerage houses. On the fiscal stimulus side, Congress has acted swiftly with a tax rebate. So no, I'm not worried that credit will dry up; I think that, as the year unfolds, the remaining troubled positions can be unwound in an orderly fashion while business gets back to usual.

What about reduced U.S. demand for exports?

Foreign nations that depend heavily on exports to the U.S. will certainly have a tougher time this year than last year. The key questions for these countries are: 1) how sensitive is their economic growth to U.S. demand?; and 2) how strong are home-grown and other non-U.S. sources of demand? In general, recent years have seen a greater “decoupling” of global economic activity, with regional growth in Europe and emerging Asia compensating for any weakness in the U.S. European GDP growth remains solid, albeit with major differences from country to country. Although China exports heavily to the U.S., it is in the midst of a massive infrastructure build that is not dependent upon the buying habits of the American consumer. India has a potentially huge economy with less sensitivity to the U.S. than most others in Asia.

However, Japan is still struggling to get domestic economic traction and is among the most vulnerable to sluggish U.S. demand for its auto and electronic exports.

What about the dollar? Doesn't a weak dollar make it even more difficult for foreign exporters? On the other hand, wouldn't a dollar rebound (i.e. foreign currency weakness) eat into international stock returns?

European economies have held up impressively despite the euro's continued appreciation, thanks to significant trade within the European Union and with emerging market countries. Given the increase in inflation (due to rising global energy and food prices), the European Central Bank (ECB) has been reluctant to lower interest rates, creating a weak dollar. That said, there is a good chance of a dollar rebound (short-lived or otherwise) at some point this year should the U.S. economy strengthen and interest rate differentials decrease. I prefer to see the upside of any currency move: dollar strength should help foreign exporters and their stock prices, while dollar weakness increases the value and necessity of holding non-dollar assets.

How attractive are international market valuations?

The equity markets are always forward looking. As a result, three or six solid months of bad news can be a good thing provided it is out in the open and in the rear view. Markets worldwide had certainly enjoyed a superb five-year run, but this was an earnings-based rally rather than a stock market bubble based on multiple expansion. Apart from the high-growth markets of emerging Asia, valuations were never unreasonable. Now they are downright attractive, even after accounting for declining profits. I tend to think that the international stock markets were sold off “unfairly” in January, given that the sub-prime problem originated in the U.S. and has had its greatest impact there. So I believe any relief in the U.S. economic data or news flow could result in a nice leveraged move to the upside by the markets overseas.

The current slowdown/recession should be short-lived

The U.S. economy slowed in the fourth quarter of 2007 to a 0.6% growth rate. This followed strong growth in the second and third quarters of 3.8% and 4.9%, respectively. The 2007 year-over-year growth rate remained at 2.5%, just below the long-term trend. The major drag on growth was once again residential investment, which was offset by strength in net exports and business investments. Consumer spending slowed but was still up 2.5%. Inventory reduction was also a major drag on growth. However, this data is now ancient history. Economic statistics released so far this year indicate a first quarter of slow or perhaps negative growth.

Although this slowdown may eventually be labeled a recession, we believe where we have been is less important than where we are going. We continue to expect growth to snap back in the second half of 2008. In recent years, economic growth has consistently surprised the pundits by being stronger than expected.

We disagree with those who are drawing analogies to the Great Depression or the collapse of the Japanese bubble in the 1990's. (For a complete discussion of this issue, see our recent piece, *Holding Back the Tide* on our Web site at www.Bailard.com/musings.html.) Two better analogies would be the 1990 and 2002 U.S. economic recoveries out of mild recessions. In 1990, a severe housing decline led to a collapse of the Savings and Loan industry. The 2000 recession was triggered by a collapse in the Technology bubble. Both the prior housing decline and the Tech bust led to only mild recessions due to the size, diversity and structural changes in the U.S. economy. Moreover, unlike the government reactions to the Japanese precedent and the Great Depression, today, American policymakers appear to be responding properly to the current economic turmoil.

Fed aggressively reducing short-term rates

The Fed has aggressively cut the overnight Fed Funds Rate to 2.25% from 5.25% in September. With inflation running around 2.5%, the real

(inflation-adjusted) short-term interest rate is negative. Historically, negative real short-term rates have triggered economic recoveries. Since it typically takes six to twelve months for the economy to respond to changes in monetary policy, the Fed's stimulus should start having a real economic impact right about now. The sharp decline in the Fed Funds rate also reduces the roll-over risk of adjustable rate mortgages (ARMs) and should help stem foreclosures. Since ARMs are tied to short rates, the 3% decline in short rates should make servicing these mortgages easier for financially strapped homeowners. Moreover, since mortgage rates are falling, ARMs can also be refinanced into fixed-rate loans, preventing a recurrence of affordability problems when interest rates do rise in the future.

The Fed has also been creative about addressing the crisis in confidence in the financial markets. The U.S. financial system has been experiencing two major problems: 1) a lack of liquidity that occurs when certain markets seize up; and 2) a pricing problem that creates valuation uncertainty and contributes to the evaporation of liquidity. In response, the Fed has created two new lending facilities to pump liquidity into the financial system and to help restore confidence and order to the financial markets. The Term Auction Facility (TAF) provides short-term liquidity to banks by allowing them to borrow from the Fed and to exchange mortgage-backed securities for Treasury paper. The Term Securities Lending Facility (TSLF) provides similar liquidity to broker-dealers. The TAF and the TSLF help support bank reserves, strengthen broker-dealer balance sheets and add much needed liquidity to the mortgage markets.

Fiscal policy is also very stimulative

Not only are 2007 tax refund checks being mailed out (they should be larger than last year's due to the growth slowdown in the

We believe where we have been is less important than where we are going.

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The current slowdown/recession should be short-lived

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fourth quarter), but a bipartisan tax rebate is on the way. Congress passed a \$168 billion tax cut, with checks to be mailed out in May. Other fiscal measures include reducing the capital requirement for Fannie Mae and Freddie Mac from 30% to 20% and increasing to a maximum of \$729,000 the cap on conforming loans that can be sold to these agencies. This should help put liquidity back into the mortgage market and increase housing affordability. Congress is also working on a Housing Act that will prevent foreclosures.

Housing outlook improving

Housing affordability has increased dramatically as mortgage rates and home prices have fallen. The National Affordability Index has jumped to 135.2, its best reading since 2003. This index indicates what percentage of a median-priced home can be afforded by a median-income household making a 20% down payment. Currently a median-income household can afford 135% of a median-priced home. Affordability is now at record highs in the Midwest and the South, but has also increased significantly in the West and the Northeast. We believe that the bleeding in the housing market is coming to an end. Given that the housing decline has pulled economic growth down 1% per annum over the last two years, a stabilization in housing would remove that drag and add 1% to growth.

The trend in net exports is higher

Strength in net exports completely offset the weakness in housing over the last year. Economic growth overseas has been relatively strong compared to the U.S., which combined with dollar weakness, has helped U.S. exporters. With the U.S. economy slowing, import growth has slowed along with consumer spending.

Stronger export growth and lower import growth reduced the trade imbalance and added 1% to GDP last year.

In summary, over the next few months, maximum monetary, fiscal and currency stimulus will be hitting the U.S. economy simultaneously. The Fed is fulfilling its role as the lender of last resort, fiscal stimulus is just around the corner, various housing programs are working to stem foreclosures, housing affordability is rising, and dollar weakness is boosting exports. As a result, we expect the current economic slowdown/recession to be short-lived.

Most international economies continue to grow

International economic growth, while in a slowing trend, has been stronger than U.S. growth. Asia continues to be a major global growth engine, but even there growth has slowed. Europe has been quite resilient despite major differences in economic activity across countries. Japan is still struggling to gain economic traction.

European growth is mixed

Economic growth in Germany and France has held up better than in Italy and Spain. The ECB has been reluctant to lower interest rates, which is putting a strain on southern Europe but appears to be an appropriate policy for northern Europe. Thus far, concerns about higher inflation have outweighed signs that the strong euro is hurting exports. Unless the European economy slows more or headline inflation declines, the ECB is likely to stay on the sidelines, which could continue to put downward pressure on the dollar. However, if we are correct on our forecast of a stronger U.S. economy, the Fed may be close to the end of its easing policy. If that is the case, the greenback could rally once the threat of Fed ease is removed and confidence in the U.S. is restored.

Japan is still sluggish

After growing at a 3.5% rate in the fourth quarter, the Japanese economy has had difficulty gaining traction. It continues to grow erratically. Weak employment and wage growth has kept household income and spending from accelerating, leaving the economy dependent on exports, which in turn are coming under pressure from a stronger yen. Business confidence, while a bit better, still remains at recession levels. After showing some signs of improvement, monetary growth and bank lending have turned down once again. On a positive note, deflation may be ending, since

Tokyo inflation rose 0.6% year over year in March and national CPI increased 1.0% year over year in February. Deflation breeds economic caution as consumers and businesses wait to buy.

Asia is slowing but still strong

Economic data out of China has been difficult to interpret due to distortions caused by severe winter weather and pre-purchases of everything from commodities to consumer goods in advance of the Olympics. As a result, imports have risen sharply even as export growth has slowed along with the global economy; this has created a modest drag from net exports. However, the domestic economy remains robust, with retail sales rising 20.2% year over year in February. The manufacturing sector also remains strong. The Purchasing Manager Index was 58.4 and Orders were 63.8 in March (above 50 for both is considered to be expansionary). Manufacturing activity could be up due to the recovery from the snowstorm and from the front-loading of production in preparation for the Olympics. The government plans to cut industrial production around Beijing in order to stem air pollution ahead of the games. After an 11.2% year-over-year growth rate in the fourth quarter of last year, growth may slow but is likely to remain robust.

The rest of Asia continues to prosper as exports to China remain strong. Taiwan's and Hong Kong's exports are growing 17% and 16% year over year, respectively. Singapore's industrial production rose 10% year over year in February, while India's exports advanced 35.3% in February from a year ago. Although the 12% rise in the rupee this year is expected to slow export growth, it should remain very healthy. India's GDP also rebounded strongly in the fourth quarter, rising 8.4% year over year.

International economic growth, while in a slowing trend, has been stronger than U.S. growth.

The flight to safety continued in the first quarter

The U.S. bond market, as measured by the Merrill Lynch Government Corporate Bond Master index rose 2.5% in the first quarter of 2008. During this period, U.S. Treasury bonds once again led the way, as the Merrill Lynch U.S. Treasury/Agency Master index advanced 4.4% after increasing 9.1% in 2007.

Credit concerns continued to push investors toward the safety of U.S. government-backed bonds and away from any credit or liquidity risk. The Merrill Lynch Corporate Master index of investment grade corporate bonds had a total return of -0.1% in the quarter, the Merrill Lynch U.S. High Yield Master index of high yield bonds fell -3.0%, and the Merrill Lynch Municipal Bond Master index was off -0.8% after returning only 3.3% in 2007.

Treasuries are overvalued

During the quarter, government infusions of liquidity and a 2% cut in the Fed Funds rate helped push Treasury bond yields down across the maturity spectrum. Yields on 90-day, two-year and ten-year U.S. Treasuries fell to 1.0%, 1.8% and 3.4%, respectively. With yields this low, there is little value in the Treasury market. We see these issues as overvalued compared to inflation, corporate bonds and other assets. The real (inflation-adjusted) yield on ten-year U.S. Treasury bonds is only about 1%, which is low by historical standards. The T-bill real yield is negative. While good for the economy, low and negative real yields do not bode well for future bond returns.

Yield spreads have increased

The yields on AA rated, ten-year municipal bonds also have risen above Treasury yields. Historically, they have averaged about 85% of Treasury yields due to tax considerations. Corporate bond yield spreads (versus Treasuries) have also widened out along the quality spectrum. Investment grade corporate bonds are yielding about 2% more than the ten-year U.S. Treasury bond, which is well above the long-

term mean spread of 1%. High yield, lower quality bonds are yielding nearly 7% more than the ten-year U.S. Treasury bond. The widening in these spreads makes corporate bonds a more compelling value for bond investors. However, to recognize this value the economic outlook needs to improve. When it does, we believe stocks will outperform bonds of every type.

At the end of the quarter and so far in April, some of the safety premium in Treasury bonds has evaporated. Treasury yields have risen and credit spreads have narrowed as investors have expressed more confidence that the government has provided enough stimulus to pull the economy out of its malaise.

Foreign Exchange

In the first quarter of 2008, the trade-weighted dollar declined -6.4% after falling -8.2% in 2007. During this three-month period, the dollar dropped -12% versus the Japanese yen and -8% versus the euro. The dollar has been under downward pressure as the credit crisis has undermined confidence in the U.S. and as the Fed has been aggressively easing. With the ECB on hold, relative interest rates have been moving in favor of the euro.

The dollar stabilized and rallied at the end of the quarter as investor confidence in the U.S. improved. If growth prospects can be maintained, the dollar should continue to rally. An improved economic outlook suggests the Fed is near the end of its easing cycle. Treasury yields should rise and stocks could rally. If so, capital flows should return to the U.S. and to the dollar. The dollar is currently extremely undervalued on a purchasing power basis, and investor sentiment is still negative. Massive shorting of the dollar suggests a substantial dollar rally at some point as shorts are forced to cover their positions. However, the long-term trend in the dollar is down and, until it reverses, dollar rallies should be sold. It may take some time for the dollar to stabilize and build a base to support a sustainable rally.

The New Year brought no relief from the bear market

For domestic equity investors, the New Year brought no relief from the bear market. A bad fourth quarter of 2007 was followed by an even worse first quarter of 2008. From its peak in 2007 to March 31, 2008, the S&P 500 fell almost -19%, while the S&P Small Cap 600/Citigroup Value index and the NASDAQ 100 index were both down over -25%. During the first three months of this year, these three indices fell -9.4%, -6.9% and -14.4%, respectively.

All style quadrants declined during the first quarter, though, in a change from 2007, value outperformed growth. According to the Wilshire style indices, small value was the best performing style, down -7.0%; followed by large value, down -8.9%; large growth, down -9.9%, and small growth, declining -12.0%.

Reasons for the decline

Anticipation of a recession seems to have been the driving force behind the market's decline. Continued banking woes, driven by a weak housing market and persistent mortgage defaults, have pushed financial stocks lower. Banks' lending practices have remained restrictive as they try to compensate for their earlier recklessness. This lack of easy credit has had a spillover effect on the rest of the economy, as businesses in other industries have had trouble financing their expansion plans. A further result of banks' reluctance to lend is that the Fed's interest rate reductions have been slow to produce a stimulative effect. Rising raw material costs, particularly energy related, have also hurt profit margins across the economy.

The outlook for U.S. stocks is improving

The old saying, "It's always darkest before the dawn" is particularly apt when applied to equity investing. The market is down and for good reasons, but we believe that conditions will begin to improve shortly. Historically, stocks have always anticipated an economic recovery,

usually long before the signs of recovery are broadly apparent.

What makes us think that a market rebound is imminent? First, stock valuations are historically low, particularly given the current interest rate and inflation environment. Second, our Chief Economist believes that, although the Fed was initially slow to react to the current downturn, its recent actions are sufficient and are beginning to have an effect. As a result, he feels that the recession is likely to be mild at worst. Third, most measures of investor sentiment are currently at levels of extreme pessimism that have not been seen since the depths of the bear market in 2002. Historically, investor sentiment is an excellent contrary indicator. When investor pessimism reached extreme levels in late 2002, the stock market began rising strongly. Over the next twelve months, the S&P 500 climbed over 33%, and the S&P Small Cap 600/Citigroup Value index jumped 46%. While past performance is no indication of future results, given the market's behavior thus far in April, we may already be seeing the end of the recent bear market.

We believe that conditions will begin to improve shortly.

International stocks also declined in the first quarter

The international equity markets, struggling to climb a “wall of worry” towards the end of 2007, lost their footing entirely and slipped back to earth at the start of 2008.

In the face of continued mortgage security write-downs, weakening economic data and earnings downgrades, investors grew increasingly fearful of the effects of a housing-led U.S. recession and a deepening global credit crunch on foreign economic growth. The MSCI All-Country World ex-U.S. index (net dividends, U.S.\$ terms) fell -9.1% during the first quarter, after declining some -15% by late January.

In broad terms, the pain was spread fairly evenly across the globe. The MSCI EAFE (developed Europe and Asia) index (net dividends, U.S.\$) fell -8.9%, while the MSCI Emerging Markets index dropped -10.9%. Nevertheless, there was a significant dispersion in returns from country to country. In what can be seen as a sharp reversal of last year's trend, former high-fliers such as Hong Kong, India, China and Turkey ended the first quarter of 2008 with the worst losses among the 48 markets in the MSCI All-Country World index. Meanwhile, such 2007 laggards as Ireland, Sweden, Mexico and Taiwan held up relatively well in the first three months of this year.

Bad as they were for U.S.-based investors, international results were even worse for the local market participants. For the sixth consecutive quarter, U.S.-based investors had strengthening foreign currencies working in their favor.

Financials and telecoms lagged; consumer staples and materials were the bright spots

Slicing the world by economic sectors, we see that financials (not surprisingly) and telecoms

(surprisingly) were the biggest drags on performance. The most help came from consumer staples (perceived safety) and materials (rising prices for metals and agricultural commodities). From an already high \$96 per barrel starting point, oil continued its ascent, touching \$110 before landing above \$101 – but this didn't translate into higher prices for energy stocks, which actually performed a little worse than the overall average.

International stocks appear more attractive now

Looking forward, we believe there is cause to be more positive on international stocks now—after a 9% price cut and a quarter's worth of bad news in the rear view—than three months ago at the end of a nearly uninterrupted five-year run. The international stock markets in general are now trading at multiples that appear quite reasonable compared to historical averages and current bond yields. Policymakers have succeeded in restoring some confidence and stability to the equity and credit markets. Even with recent financial-sector earnings downgrades, economic growth overseas remains healthy (outside of Japan), supporting earnings among companies operating in the “real” economy. Finally, we believe emerging markets still represent a very attractive long-term opportunity, with growth rates well ahead of the developed world and, to date, an ability to withstand the current crisis that has been greater than many had expected.

The investment property market remains relatively unruffled

Eight months have passed since the sub-prime crisis began. Since then, fear has spread its effects over all debt markets, especially the commercial mortgage-backed securities market where the new issuance level continues at zero. In spite of this, the investment property market—especially at the institutional level—remains relatively unruffled.

Capitalization (“cap”) rates have rebounded from their bull-market lows, with about a 25 to 50 basis point (0.25% to 0.5%) rise on average, except for apartments, which continue to be relatively strong. (An increase in cap rates correlates to a decrease in prices.) Hidden in these general statistics, however, is a much larger rise in cap rates for lower-grade properties or properties located in tertiary markets. Essentially, the market has reverted to pricing in the inherent risks of different properties. When money was plentiful, there was very little difference in these cap rates.

The volume of transactions has slowed

The biggest impact so far has been on the level of transactions. According to Real Property Analytics, the total dollar volume of property transactions over \$5 million during the first two months of this year was only \$22.3 billion, down 78% from \$101.8 billion in the same period of 2007. The biggest decline was in office buildings, where the market peak last year was marked by the purchase of the Equity Office Properties portfolio by Blackstone. The decline in transactions appears to be the result of patient sellers. Most of them are not under any pressure to sell and are waiting for buyers to meet their price. In contrast to the \$22 billion of closed properties so far this year, the newly offered properties totaled \$46.3 billion. If sellers become less patient, we could see further rises in cap rates.

Office buildings pose the biggest risk

With regard to the outlook for the various core property types, we see the biggest risks in

office buildings. Not only are job losses likely to reduce demand for space, but the new completions of late last year are already moving the vacancy rates up to 14.3% from the 13.6% in 2007. With all of the herd mentality in recent years about “buying offices to take advantage of the coming rent spikes,” we have very little evidence of rent spikes so far, beyond a few key markets such as New York, Washington, D.C. and San Francisco. According to SNL, a public REIT analytics firm, “same store” net operating income for office buildings owned by REITs rose about 2% last year, compared to a 4% to 5% increase for the other property types. As the market begins to digest its over-exuberance in buying office buildings, our analysis suggests portfolios with significant office exposure could well underperform the next couple of years.

Retail may also be at risk

In our opinion, the other risky property type is retail, where high rates of new construction continue the two-year rise in the vacancy rate, though it still only stands at 7.5% nationally. Multifamily properties continue to look attractive, as the unqualified buyers of homes with sub-prime loans are forced back into the rental market. Even though new construction continues at reasonably healthy levels, vacancy rates remain low in most markets and average less than 6% nationally.

Return expectations should be lowered

Perhaps by the end of 2008, the picture will become clearer. Meanwhile, we believe institutional property investors should be prepared to see basically flat total returns, as income is offset by gradual price erosion. Our analysis suggests 2009 to 2010 should see a return to stability, with high single-digit returns likely to become more normal.

The biggest impact so far has been on the level of transactions.

Our allocation to equities has fluctuated as market conditions have changed

In April, we added back to U.S. stocks.

After ending 2007 with solid gains, the global stock markets hit an air pocket in January. Most equity markets dipped to their lowest levels in the second or third week of January and spent the rest of the quarter putting in a volatile bottom. Given the downdraft, in January, we reduced our allocation to global stocks for defensive purposes. However, we maintained an overweight position and our favorable outlook for equities longer term. In April, we added back to U.S. stocks, as the market showed signs of setting up a tradable bottom and the government applied maximum stimulus to the economy.

Global Bonds: Underweight

Treasury bonds were one of the few assets that had a positive return for the quarter, as money still flocked toward safe haven assets. As a result, ten-year Treasury yields became even more unattractive, falling to 3.4%. Meanwhile, the widening in yield spreads has restored value to the corporate, junk and municipal bond markets. We continue to hold some bonds for diversification purposes but remain underweight in this asset class. While value has been restored to some bond sectors, we'd prefer to be in stocks in the improving economic environment, which would be needed for credit spreads to narrow and that value to be realized.

U.S. Stocks: Overweight

Stock valuations became even more attractive in the quarter, as the S&P 500's price-earning ratio fell to 13 times forward earnings. The markets have already discounted a mild recession. Since markets are forward looking, if economic conditions improve, stocks could move significantly higher well before the economic trough in anticipation of an economic recovery. Since World War II, stocks historically have moved upward on average five months before the economic trough and have risen an average of 20% between the trough in stocks and the end of the economic downturn. Rallies off the bottom can be powerful. Today, conditions

for a turning economy and market are being put in place. The unemployment rate is low, real interest rates are falling, inventories are low, cash flows are positive, and policy makers are applying maximum fiscal, monetary and currency stimulus.

In January, we reduced our equity positions as a precautionary move while waiting for the market to put in a bottom. We believe a solid bottom has been established, and in April added back to our U.S. equity positions.

International Stocks: Overweight

Although the world's economies appear to have decoupled, the global equity markets have not. International stocks fell along with U.S. stocks in January. International stock valuations have improved and are as attractive as those of U.S. stocks. However, given recent signs that the dollar may have temporarily bottomed, we are not currently looking to increase our international stock allocation.

Real Estate: Neutral*

Commercial real estate activity has slowed, with the number of transactions falling over the last year. The slowdown has led to a small increase in capitalization rates to 5.9%. This is still relatively attractive compared to Treasury bond yields below 4% and T-bill yields at around 1%. Real estate remains our preferred portfolio diversifier. In addition, active management provides the opportunity for adding value at the property level.

Alternative Investments: Neutral*

The recent financial market turmoil reinforces our belief in using alternative assets to offset the risks inherent in equity portfolios. Given the lack of yield in the money markets, alternative assets (such as long-short strategies designed to reduce volatility) can provide important diversification benefits.

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

U.S. INTEREST RATES

	6/30/2007	9/30/2007	12/31/2007	3/31/2008
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Cash Equivalents

90-Day Treasury Bills	4.81%	3.81%	3.25%	1.33%
Federal Funds Target	5.25%	4.75%	4.25%	2.25%
Bank Prime Rate	8.25%	7.75%	7.25%	5.25%
Money Market Funds	5.14%	5.06%	4.59%	2.85%

Bonds

30-Year U.S. Treasury	5.13%	4.84%	4.45%	4.29%
20-Year AA Municipal	4.40%	4.28%	4.38%	4.79%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 3/31/2008

	QUARTER	YEAR TO DATE	ONE YEAR
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U.S. Bonds

Merrill Lynch 7-10 year Treasury Index	6.17%	6.17%	15.21%
Merrill Lynch 7-10 year Agency Index	3.55%	3.55%	11.15%
Merrill Lynch 5-10 year Corporate Index	0.06%	0.06%	2.60%
Lehman Bros. Municipal Bond Index	-0.61%	-0.61%	1.90%

International Bonds

Citigroup non-U.S.\$ World Government Bond Index, fully hedged	2.14%	2.14%	6.15%
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Sources: Bloomberg L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 3/31/2008

	QUARTER	YEAR TO DATE	ONE YEAR
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U.S. Stocks

Dow Jones Industrial Average	-7.00%	-7.00%	1.57%
S&P 500	-9.44%	-9.44%	-5.08%
NASDAQ 100	-14.42%	-14.42%	1.04%
S&P SmallCap 600/Citigroup Value	-6.45%	-6.45%	-13.19%

International Stocks

MSCI Japan, net dividends	-7.81%	-7.81%	-14.71%
MSCI Europe (includes UK), net dividends	-8.62%	-8.62%	0.18%
MSCI EAFE (Europe, Australia, Far East), net dividends	-8.91%	-8.91%	-2.70%

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

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 3/31/2008

	QUARTER	YEAR TO DATE	ONE YEAR
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NCREIF Property Index*	3.21%	3.21%	15.38%
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*Return for latest quarter is an estimate.

Source: The National Council of Real Estate Investment Fiduciaries

Past performance is no indication of future results.

Sonya Thadhani, CFA
Chief Investment Officer

Dana D. Hobson, PhD, CFA
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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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