

BAILARD INTERVIEW

Questions and Answers

In this expanded edition of *the 9:05*, Bailard's Chief Economist and Investment Strategist Arthur A. Micheletti reflects on the emotional impact of the bear market and answers some key questions from our clients.



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Currently, everyone is anxious about the state of the financial markets and the outlook for the economy. These concerns are well justified, as the stock markets decline, our financial and political institutions search for solutions and the media focuses attention on all the turmoil. We could be experiencing the worst crisis of confidence in the U.S. financial system since the Great Depression. In times like this, emotions run so high that it is easy for investors to abandon their disciplines and extrapolate their fears well into the future. In times like this, when discipline is most needed, it is the most difficult to maintain. Although this has been a difficult environment, we take comfort in our investment philosophy, long-term strategies and investment disciplines. We also take comfort from and appreciate the ongoing support and confidence of our clients.

As you can imagine, in difficult market environments, the volume of questions we get from clients tends to go up proportionally with the level of anxiety. We address some of these questions in the interview below. Our investment counselors and research staff are also

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available to address any other questions you may have.

How does this market decline compare to other bear markets?

Since 1948, there have been sixteen periods in which the S&P 500 stock index has fallen -15% or more. As Table 1 indicates, the S&P 500 declined an average of -25.7% in these bear markets, which lasted an average of 237 days. In the current correction, the S&P 500 has declined -37.9% in the 364 days from October 9, 2007 to October 8, 2008. This has been a long, deep bear market by historical standards. Although past performance is no indication of future results, if history is any guide, the correction should be near its bottom.

This has been a long, deep bear market by historical standards.

Table 1

Bear and Bull Markets, 1948-2008
S&P 500 Index Returns (excluding dividends)

Bear Market Dates				Bull Market Dates			
High Date	Low Date	%Loss	#Days	Low Date	High Date	%Gain	#Days
6/15/1948	6/13/1949	-15.78	363	6/13/1949	7/15/1957	458.21	2,954
7/15/1957	10/22/1957	-19.8	99	10/22/1957	12/12/1961	114.36	1,512
12/12/1961	6/26/1962	-26.78	196	6/26/1962	2/9/1966	100.84	1,324
2/9/1966	10/7/1966	-20.47	240	10/7/1966	11/29/1968	58.42	784
11/29/1968	5/26/1970	-32.86	543	5/26/1970	1/11/1973	88.78	961
1/11/1973	10/3/1974	-45.02	630	10/3/1974	2/13/1980	142.64	1,959
2/13/1980	3/27/1980	-16.56	43	3/27/1980	11/28/1980	47.93	246
11/28/1980	8/12/1982	-20.25	622	8/12/1982	8/25/1987	302.75	1,839
8/25/1987	10/19/1987	-32.96	55	10/19/1987	7/16/1990	79.66	1,001
7/16/1990	10/11/1990	-19.21	87	10/11/1990	7/17/1998	389.02	2,836
7/17/1998	8/31/1998	-19.19	45	8/31/1998	9/1/2000	62.92	732
9/1/2000	4/4/2001	-26.93	215	4/4/2001	5/21/2001	19.2	47
5/21/2001	9/21/2001	-26.11	123	9/21/2001	3/19/2002	22.01	179
3/19/2002	7/23/2002	-31.48	126	7/23/2002	8/22/2002	20.87	30
8/22/2002	10/9/2002	-19.12	48	10/9/2002	10/9/2007	119.43	1,826
10/9/2007	10/8/2008	-37.9	364				
	Mean	-25.65	237		Mean	135.14	1,215

Source: Ned Davis Research. Past performance is no indication of future results.

Table 1 also shows that the bull markets after 15% or more market declines had an average return of 135.1% and lasted 1,215 days. Bull mar-

kets historically are more powerful and last longer than bear markets. That is why stocks typically win in the long run.

You have been optimistic about the stock market through most of this decline. What went wrong?

We believed that stocks were attractively valued, the economy would bend but not break, inflation would be contained, oil prices would decline, the Fed would aggressively ease and earnings outside the financial sector would remain healthy. All of these things occurred or were true.

However, the market's singular focus as the year progressed became the financial crisis. We clearly underestimated both: 1) the breadth and the depth of the financial crisis; and, more importantly, 2) how much a climate of fear would prevail, leading the market to divorce itself from underlying fundamentals. In particular, we failed to see how the application of a

new accounting rule would lead institutions to rapidly write down assets to levels that were not reflective of true underlying value, triggering a vicious cycle of distressed sales and more asset writedowns that dramatically magnified

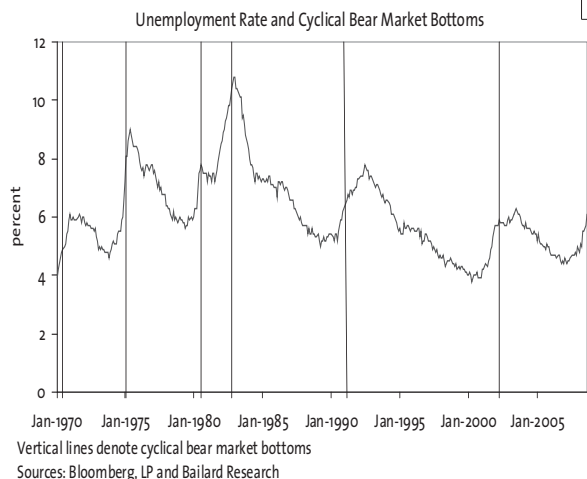
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the problem. We were surprised that all the attempts to stabilize the situation failed and that financial institutions were being picked off one by one. Every time it looked like the markets were turning the corner, they were hit with another piece of bad financial news. We were also disappointed and frustrated with the inadequate regulatory response to the asset valuation and short selling problems (see *U.S. Economy* for more details). We believe much of the current financial distress was self-inflicted by a slavish adherence to the new accounting regulation and by the lack of regulatory oversight of short selling rules.

Given all the financial uncertainty, why don't you just raise some cash and wait until things get better?

Cash yields, at near zero, are currently extremely unattractive. Historically, periods of low cash yields are good times to be invested in equities. In addition, stocks tend to lead economic activity, and the stock market typically turns up long before it is clear the economy is improving. For example, major stock market bottoms historically have occurred long before the unemployment rate has peaked (see Chart 1).

Chart 1



Finally, rallies off the bottom tend to be very powerful. The most important reason you should be careful being out of stocks is that missing market turning points can do serious damage to your long-term returns. Table 2 shows what would have happened to U.S. stock returns as measured by the S&P 500 (ex-dividends) if you were out of the market for various periods. Missing the ten best days out of the 9,593 market days from December 31, 1969 to December 31, 2007 would have reduced your return for a buy and hold strategy from 7.56% to 6.04% per annum. If you started with a \$10,000 investment and missed the ten best days, you would have accumulated only \$99,275 rather than the \$148,278 you would have had if you had bought and held the entire time period. In other words, you would have had 50% more if you had been in the market during those ten best days.

Rallies off the bottom tend to be very powerful.

Table 2

Gain/Annum (%) of S&P 500 Stock Index Excluding Best Days
12/31/1969 - 12/31/2007; Price Change Only

Number of Days Excluded*	10	20	30	40	50
Return/Annum (%)	6.04%	4.88%	3.84%	2.90%	2.02%
Cummulative Growth of \$10,000	\$99,275	\$58,294	\$40,317	\$28,798	\$20,958

Buy/Hold Gain/Annum = 7.56% (ex-dividends).
Growth of \$10,000: \$148,278

*There were 9,593 market days in the last 37 years. Ten days equals 0.10% of those.

Sources: Ned Davis Research and Bailard Research
Past performance is no indication of future results.

Stocks have not done well over the last ten years. Why should I own any stocks?

This has been a tough period for stocks - one of the worst ten-year periods in U.S. history. However, the starting and ending points for performance measurement are

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very important. The current ten-year period began well into the Tech Bubble, which was followed by a bust. It is ending with a sharp bear market. Other ten-year time periods have had much better returns. Over the long term, stocks have significantly outperformed other asset classes.

In our opinion, what happens in the next ten years is more important than what has happened in the past ten years. Given the starting point of a seriously depressed market and extremely cheap valuations, we believe the next ten years should be much better. Table 3 shows the starting yields for various assets, their potential income growth and the outlook for upward revaluation. From a value perspective, stocks win hands down. Whether the market turns tomorrow or six months from now, our analysis indicates stocks over the next five to ten years are likely to work back toward long-term mean returns. This suggests the potential for higher returns going forward.

We believe the financial rescue package will be a success.

Table 3
Long-Term Return Prospects

Asset	Starting Yield	Potential Income Growth	Yield + Growth	Potential Valuation Change
Cash Equivalents	0.33%	0%	0.33%	up
U.S. 10-yr. Treasury	3.46%	0%	3.46%	down
Baa Corp Bond	7.9%	0%	7.9%	up
U.S. Stocks (E/Y)	9.2%	6.0%	15.2%	up
Intl. Stocks (E/Y)	9.3%	7.5%	16.8%	up
Real Estate	5.8%	2.5%	8.3%	neutral

Sources: Bloomberg, LP and Bailard Research

There is no guarantee these forecasts will be achieved.

Will the government's financial rescue package work?

We believe the financial rescue package will be a success. It addresses the asset valuation issue that is at the heart of the financial crisis. The history of financial rescue packages both inside and outside the U.S. is also encouraging, particularly since the size of today's \$700 billion program as a percent of GDP is comparable to or smaller than most of them. All of the following rescue plans successfully purchased and sold troubled assets at a cost much less than originally estimated. Moreover, the number of bank failures today is relatively low by historical standards.

- In 1933, the U.S. government established the Homeowners Loan Corporation (HOLC) to refinance home mortgages and sell foreclosed homes. HOLC acquired and refinanced over twelve million homes or about 20% of outstanding mortgages. The corporation was funded with \$2 billion or 3.5% of GDP. In 1932, during the Great Depression, 4,190 banks failed or about eleven per day.
- In 1985, the U.S. government set up the Federal Asset Disposition Association, which was rolled up into the Resolution Trust Company in 1989. The combined entity absorbed \$519 billion in Savings & Loan (S&L) assets equal to 9% of GDP. The final cost to the taxpayer after the assets were liquidated was \$124 billion. In 1990, during the S&L crisis, 211 S&Ls and 169 banks failed at a rate of about seven per week.
- In 1992, Sweden bailed out its banks in an amount equal to 6% of GDP. By 1997, when the program ended, the taxpayers broke even.
- In 1998 during the Asia Crisis, Hong Kong authorities intervened in that country's

Questions and answers (continued)

stock market to halt a sharp market slide. They purchased stocks in an amount equal to 5% of GDP. The taxpayers ended up more than doubling their money.

By comparison, the Economic Stability Act of 2008 calls for \$700 billion to be allocated in tranches to purchase troubled assets from banks and resell them sometime in the future. This amounts to 5% of GDP. If done correctly, the final cost should be much less than \$700 billion and the taxpayer could actually come out ahead. Currently, 117 banks are on the Federal Deposit Insurance Corporation's watch list. That's about 1.4% of the 8,400 banks in the U.S. So far, the number of bank failures has been relatively small at about one per month this year.

Why won't this be like the Great Depression or the decade-long financial crisis in Japan?

The Great Depression was aggravated by a number of policy mistakes. Instead of aggressively easing, the Fed actually raised rates and shrank the monetary base by 30%. Fiscal hawks increased taxes in an effort to balance the budget. Finally, the Smoot-Hawley Act raised tariffs on imported goods by 45% and triggered a protectionist war with our trading partners. Currently the Fed is aggressively easing monetary policy, tax hikes are not imminent, and a massive protectionist push to the extent of Smoot-Hawley is unlikely.

Japan's situation at the onset of its crisis was dramatically different than ours is today. The country experienced a "double bubble" preceding its shock, as both real estate and stock prices rose to extreme valuations. Prices for residential and commercial real estate inflated at rates much faster than what the U.S. has seen over the past five years. In addition, the prices investors were willing to pay for Japanese stocks rose from 27.3 times earnings in December of 1984 to a colossal 51.8 times earnings in December of 1989. In contrast, the P/E multiple

for U.S. stocks declined from 27.1 to 18.0 times earnings in the five years before our market downturn began.

Japan was incredibly slow in recognizing the impact of the bursting bubbles upon its banking system. This exacerbated a bad debt problem that culminated in banks writing off \$1 trillion in bad debt over ten years. In contrast, the U.S. financial system has sharply written down its bad debt over the last year. (If anything, it has probably written the debt down too much). The Japanese also repeated some of the mistakes of the Great Depression by raising taxes and tightening monetary policy to protect the yen. Raising taxes and interest rates only hurt their recovery efforts. It wasn't until the Bank of Japan lowered rates to almost zero that the economy stabilized. Currently the Fed has engineered a decline in both nominal and real interest rates.

Currently, the Fed is aggressively easing monetary policy, tax hikes are not imminent, and a massive protectionist push is unlikely.

The U.S. economy will need time to recover

We expect the financial crisis to be favorably resolved and vehemently disagree with the view that the U.S. is in an unstoppable decline. The causes of the current turmoil are identifiable and are being addressed.

Causes of the turmoil

In hindsight, it is easy to identify the causes of the housing bubble, bust and financial crisis. The problem started with a monetary policy that was too easy for too long and was exacerbated by a regulatory push to increase home-ownership and by lax regulatory oversight. In a fundamental change in banking practices, loans were securitized by bundling and selling them to investors almost as soon as they were made. No longer did banks make loans based on the borrower's ability to repay. Instead, they lowered lending standards to make loans as quickly as possible to generate fees. As the housing bubble inflated, banks became more creative in how they financed home purchases, offering mortgages with no down payments, no documents, adjustable rates, interest only payments and anything else they could think of to squeeze people into homes. Some individuals bought homes they couldn't afford in the expectation that prices would continue to increase.

Investment banks like Lehman, Merrill Lynch and Bear Stearns all contributed to the boom and bust by increasing the amount of leverage on their balance sheets. In 2004, the SEC abolished the Net Capital Rule of 1975 that required broker-dealers to limit debt-to-net capital ratios to 12:1. As a result, many broker-dealers took on leverage of over 30 times net capital. This whole process was encouraged and supported by Congress and under the watchful eye of credit rating agencies that failed to accurately evaluate risk. As with all bubbles, everyone came to believe that home prices could only go up and

rising prices would bail them out of bad decisions.

When the housing bubble burst, many sub-prime mortgages went into default. The market for these mortgage-backed securities quickly dried up due to a lack of transparency over who held these securities and just how risky they were. At the core of the problem was the issue of how these securities should be valued given a new accounting rule that went into effect in 2007. Financial institutions began writing down the value of mortgage-backed securities to distressed sale prices, putting pressure on their capital ratios and triggering a vicious cycle of distressed sales to raise more capital and more asset writedowns. More and more financial institutions went bankrupt, were taken over by other companies or were rescued by the government. It didn't help that short sellers, benefiting from lax regulatory oversight, put additional selling pressure on vulnerable financial institutions. The financial crisis spread overseas as well.

September Tipping Point

In September, the financial crisis reached a tipping point as the failures of some of America's largest financial institutions (Freddie Mae, Fannie Mac, Lehman Brothers, Merrill Lynch, and American International Group) triggered a widespread loss of confidence in the U.S.'s financial system. Although the government responded with bailout legislation and other emergency measures, the credit crunch on Wall Street began to spill over into Main Street as businesses and consumers found it difficult to obtain financing for everyday activities.

The scope of recent financial events has been startling. Any future forecast is obviously dependent upon how the banking crisis is resolved. Financial activity has seized up and

The U.S. economy will need time to recover (continued)

risk is being priced into every conceivable asset class. Corporate credit spreads have widened dramatically, U.S. Treasury yields have plummeted, global equity prices have fallen sharply, and commodity prices are falling. All these market indicators tell us that fear is being priced into the market. Will these fears be recognized? We don't think so. We strongly believe that, given the history of stock market cycles and investor behavior, financial historians will look back on the summer and early fall of 2008 as one of the greatest buying opportunities of all time.

From here, we see three possible economic outcomes:

1. Severe Recession/Failure to Restore Confidence (Probability 20%):

If the banking crisis continues to spin out of control, the economy could spiral down along with it. We see this as the least likely scenario and actually believe the probability of this outcome has declined in recent weeks. Historically, when problems are well recognized, solutions are typically forthcoming. While it has been painful to watch our elected officials in action, this problem has gotten everyone's attention. Viable solutions are on the way.

Although the Economic Stability Act of 2008 is not the ideal solution to the banking crisis, it does get to the heart of the problem - the mispricing of mortgage-backed debt. Under the new accounting rule that went into effect last year, corporate assets must be marked to market, that is, valued at market prices. This makes sense when assets trade in liquid, transparent markets where price discovery is free of duress. However, in today's environment, the market for mortgage-backed securities has dried up. The only transactions we have seen are at distressed prices, which are being used as marks to set the value for all similar assets held in financial institution portfolios. Assets are being priced to distressed value, not to fair value. Although the

vast majority of these assets are continuing to receive cash flows, they are being priced as if they were in default. It would be as if your neighbor was forced to sell his home immediately at a distressed price and the value of every other home on your block was written down to the point where collateral values were zero and personal balance sheets were reduced to rubble. Fannie Mae and Freddie Mac didn't fail because underlying mortgages weren't paying and cash flows were negative; they failed because their assets were being written down and their balance sheets had become shaky.

If the financial stability plan can restore liquidity to the market and assets can be valued based on cash flows or other measures of intrinsic worth, the vicious cycle of writedowns, falling capital, more asset sales and more writedowns should end. The threat to bank capital and capital ratios should ease, allowing banks to more aggressively lend.

2. Restoration of Confidence/ Above Trend Growth (Probability 20%):

Over the next year, we could see better than expected growth. Historically, the strongest periods of growth tend to occur immediately after periods of economic weakness or recession. We see the prospects of above trend growth over the next year as being as likely as dropping into a severe recession.

With the passage of the financial stability package, a major impediment to growth (bank willingness to lend) should be removed. The Fed is finally aggressively pumping liquidity into the banking system. Bank reserves, the base from which all bank lending originates, are now expanding dramatically after a year of minimal increases. As banks become comfortable with their capital positions, they should begin to lend more aggressively. Moreover, the cost of funds is extremely low and well below lending rates,

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The U.S. economy will need time to recover (continued)

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giving banks a big incentive to increase lending. In other words, the margin in their core business of lending is very healthy.

Other more traditional preconditions for growth are also in place. Both nominal and real interest rates are low. The yield curve is positive (short interest rates are below long rates), which is typically a precursor of stronger growth. Inflation is declining, oil prices are falling sharply, and unit labor costs are decreasing. Lower inflation tends to boost real incomes and consumer purchasing power. Inventories are under control and are not an impediment to growth.

Although the housing sector remains soft, there are signs that prices are stabilizing. Affordability has increased sharply due to falling home prices, and it is now back to pre-bubble levels. So the problem for homebuyers is not affordability but obtaining financing and overcoming a "wait and see attitude" as they try to buy at the market bottom. If banks increase their willingness to lend and buyers start buying, the next up cycle in housing could begin in the next year. A mere stabilization in housing activity could add significantly to GDP growth.

3. Base Case: Slow Growth/Mild Recession (Probability 60%):

We assign our highest probability to this scenario. The economy and the financial system are in shock. Even if the financial stability package works as expected, the patient is unlikely to jump up off the gurney and start running laps around the hospital. It will take time for business and consumer confidence to be restored. It will also take time to see how the rescue package works in reality rather than just on paper or in theory.

While the fundamentals of homeownership have improved significantly, the housing sector remains in a downturn. Its recovery will be delayed if buyers wait to be convinced that we have seen the market bottom. Global economic activity is slowing, and exports could be weaker than we have seen over the last couple of years.

With the economic momentum clearly weakening due to financial conditions, GDP growth in the next quarter or two is likely to be weak and perhaps even negative. However, the downturn is not expected to be severe, given the diversity and resiliency of the U.S. economy, which managed to grow despite all the financial turmoil over the past year.

GDP growth in the next quarter or two is likely to be weak and perhaps even negative.

Growth continues to slow overseas

European growth is slowing amidst financial market turmoil. Fiscal and monetary resources are now being aggressively focused on the problem.

European growth has slowed dramatically. Both exports and domestic growth have weakened as the global financial situation has deteriorated. Europeans are also grappling with their own banking issues. From the U.K. to the Netherlands to Ireland and France, financial institutions have required governmental assistance. Initial policy responses varied as the region vacillated between a Pan-European response (supported by France's leader Nicolas Sarkozy) and solutions on a market-by-market basis (supported by Angela Merkel of Germany)

Rescue efforts in Europe

In September, the central banks of Belgium, Luxemburg and Netherlands stepped in to rescue Fortis, a provider of banking and insurance services. The governments took a 49% stake in the company in exchange for a \$16.3 billion infusion of capital.

The U.K. nationalized Bradford and Bingley's mortgage unit and sold off the savings business and branches to Banco Santander. The government also brokered a takeover of HBOS (the country's biggest mortgage lender) by Lloyds TSB Group. The government had already guaranteed all savings at Northern Rock, the mortgage lender nationalized in February. Given the 100% deposit guarantee, savers at other banks transferred their assets to Northern Rock. The government in response had the bank turn away depositors to ensure that its consumer deposits didn't exceed 1.5% of the U.K. savings market. Savers also moved money to Irish banks. On September 29th, the Bank of Ireland was forced to guarantee bank deposits and it may extend the guarantee to foreign banks with significant operations in Ireland. In an effort to stop these outflows, the U.K. government raised deposit

protection to £50,000 (\$88,500) from £35,000 (\$61,900). The Bank of England has also aggressively pumped money into the credit markets and has extended the range of collateral it will accept in its auctions.

German officials had to orchestrate a €35 billion (\$49 billion) rescue package for Hypo Real Estate, a financial holding company that finances real estate projects and invests in mortgages. It was given a lifeline after its Depfa Bank unit failed to get short-term funding amid the global credit crunch.

The European Central Bank, which had been asleep as the European economy slowed, seems to have awakened. In October, it joined six other central banks in reducing interest rates around the world.

Asian growth is slow but positive

Asian growth has not been immune to weakness in the U.S. and Europe. Asian exports have slowed and this weakness has spread through the domestic economies. Despite the financial problems, growth remains positive and well above the global average. Hong Kong, Taiwan and South Korea are still expanding at around 4%, while China and India are growing at 10% and 8%, respectively. Although these growth rates are likely to slow over the next quarter or two, policies are shifting to stimulate growth.

With inflation falling fast, the economy slowing and residential real estate and equity markets under pressure, the Chinese government is easing both monetary and fiscal policy. It is continuing to push forward with its infrastructure building plans and its rebuilding efforts after this year's earthquake. China remains a dominant destination for Asian exports, and increased stimulus by China should support exports from other regional economies.

European growth has slowed dramatically.

Debt yields spiked in a dramatic flight to safety

The fixed-income market has experienced extreme dislocations.

Investors have rightfully focused their attention on the stock markets for the past quarter. However, the fixed-income market also experienced extreme dislocations during this period. The Merrill Lynch Master bond index, one of the broadest measures of the U.S. bond market, fell just -0.3%. But this is like saying you drowned in a pool that averaged two feet in depth. At the shallow end, Treasury debt rose 2.3%. At the deep end, broad corporate debt experienced its worst return relative to Treasuries in history and its worst absolute return since the first quarter of 1980. According to Merrill Lynch, investment grade corporate debt fell -7.5% for the quarter. High yield debt, to no one's surprise, fared even worse, declining -9.5%, its worst performance ever.

Flight to safety

The one asset investors couldn't get enough of during this crisis was U.S. Treasury debt. This reached its most extreme in September, when investors, terrified by owning anything but the shortest and safest asset they could envision, were willing to lend the government money for almost no compensation by buying four-week maturity U.S. Treasury bills yielding 0.05%. All other forms of debt were sold without discretion. In some cases it was justified, as major financial debtors that began the quarter in the investment grade universe were bankrupt by quarter's end, leaving bond holders with pennies, or less. Yield spreads on AAA-rated debt reached almost triple their highest levels in history. By the end of the quarter, high yield debt was offering the few buyers still willing to lend eleven percent more yield than on comparable maturity Treasury debt.

Yields on municipal debt increased as well, raising yields relative to Treasury debt to record levels. In the quarter's final month, an estimated \$48 billion flowed out of tax-exempt money market funds. By this time, these funds were

yielding almost twice their taxable counterparts. Farther out the municipal yield curve, five percent coupons are appearing again and may begin to draw in investors who are more sanguine that the actions taken to quell this crisis will prevent further economic deterioration at the local level.

Cash was not king

Even the usual dictum during an equity crisis that "cash is king" was turned on its head, as the traditionally safest investment area became mired in the broader credit crisis. The same fears that drove long-term yield spreads wider besieged the money markets as well. Investors fled money market funds in favor of pure Treasury exposure, driving short-term corporate yields to extremes. LIBOR, a measure of interest rates charged between banks, exploded to record-breaking levels. Since commercial paper (the shortest term borrowing for corporations) is highly related to the LIBOR, many corporate balance sheets got caught in the same squeeze.

Importance of bailout efforts

Since September, the U.S. government has taken more and more unprecedented steps to help prevent the liquidity crisis and the anxiety it causes from becoming a self-fulfilling prophecy. The effective nationalization of Fannie Mae, Freddie Mac and American International Group may have seemed opprobrious on the surface. However, those actions were necessary to keep the economy from seizing up, since the failure of large institutions has a multiplier effect on the economy. All of the government's other bailout actions have been designed to allow banks and other financial institutions to recover enough confidence to resume lending to businesses and homeowners again. Without this, companies will be reluctant to make any large capital outlays for fear the credit to pay for them will be taken away or driven to extreme prices. This can lead to deflationary pressures if

Debt yields spiked in a dramatic flight to safety (continued)

too many economic agents begin to delay purchases.

Through this process, we will see increased near-term borrowing by the U.S. government. Fortunately, compared to our own history and many other large developed markets, the U.S. currently maintains a relatively modest level of debt at about 60% of GDP. This can be expanded dramatically before the U.S. risks losing its status as the world's premium AAA-rated issuer of sovereign debt.

Foreign Exchange

One of the most perverse reactions through this quarter's crisis occurred in the currency markets. Although the financial crisis began in the U.S., our dollar was the strongest major currency for the quarter. It advanced about 11% versus both the euro and the British pound. The yen proved itself the most resilient of any foreign developed market currency, performing in-line with the dollar over this time period.

Before this crisis began, analysts had been forecasting the dollar's demise on the basis of the U.S.'s more than \$700 billion current account deficit. The other side of this coin, though, is that the weakness the dollar has exhibited over the past several years has put America on sale for many foreigners. For instance, last year capital investments from overseas either in direct investments or securities amounted to more than \$2 trillion, swamping our trade-related deficit.

More recently, Japanese companies have been purchasing American assets at very cheap prices. Mitsubishi UFJ has invested billions in Union Bank of California and Morgan Stanley, while Nomura has picked up the Asian and European operations of now-defunct Lehman Brothers.

Both the Fed and the European monetary authorities have cut interest rates and eased aggressively since the end of the third quarter. The risks of inflation that caused central bankers to hedge earlier this year are being replaced with a more concerted focus on pulling their economies back from the abyss. Growth is slowing faster in Europe than in the U.S., so, even with extremely low Treasury yields, we may continue to see near-term dollar strength. The dollar had been aggressively over-sold prior to this rally, but at some point next year we'd expect to see renewed dollar weakness.

Although the financial crisis began in the U.S., our dollar was the strongest major currency.

U.S. stocks declined during the quarter

Domestic stock market returns were generally negative in the third quarter, compounding the declines experienced over the past twelve months. The S&P 500 fell -8.4% for the quarter and -22.0% over the last year. The NASDAQ 100 slumped -13.1% for the quarter and -23.4% for the year. Small cap value stocks, as measured by the S&P/Citigroup 600 Small Value index, actually rose 2.3% for the quarter, but still declined -13.0% for the last twelve months.

As this long and painful bear market unfolds, it is important to keep a few crucial points in mind. We have been witnessing, firsthand, why stocks historically have outperformed bonds and cash over the long term. Stocks are more volatile, and therefore investors require compensation for tolerating this greater volatility. Those invested in the market now have largely paid their dues. We believe that, if they can just hang on a little while longer, they should begin to collect their compensation as stocks rebound.

Market bottom may be near

Why do we feel that the stock market may be close to turning around? As noted in the interview section of this newsletter, the current downturn has been longer and deeper than the average post-World War II bear market. Stocks are cheap now, trading at just over 10x forward earnings. The steep writedowns in the financial sector, caused by well intended but misguided accounting rules, should be followed by similarly steep writeups as the current crisis passes, potentially boosting S&P 500 earnings by 20% or more next year. Investor sentiment, traditionally a highly accurate contrary indicator, is by most measures at or below the extreme low levels reached at previous stock market bottoms. Similarly, the earnings yield (the inverse of the price to earnings ratio), is currently much higher than the ten-year U.S. Treasury bond yield, a relationship that has historically been associated with market troughs.

Plenty of cash is also on the sidelines and could return to the stock market as fear subsides. According to Ned Davis Research, money market fund assets have risen to over 25% of total stock market value, more than double the historical average and very close to record high levels. Individuals and mutual funds cash holdings are at similar peak type levels.

There is also some good news out there, though it is often hard to notice due to the media's continual proclamations of doom and gloom. Oil's price decline from \$140 per barrel to \$90 currently is the equivalent of giving consumers an immediate tax cut. Export growth fueled by demand from China, India and other developing countries should keep U.S. GDP growth stronger than most people expect. Consumer spending may also hold up better than expected.

Contrary to popular belief, only one-third of individual net worth in this country is held in residential real estate. The housing market decline, while significant, is not the sole determinant of consumer behavior.

Stay the course

Rudyard Kipling once said, "If you can keep your head when all about you are losing theirs . . . Yours is the Earth and everything that's in it." Many investors, spooked by recent bad news and market declines, have given up on the stock market. Their capitulation has driven stock prices down to extremely attractive levels. For those who have the resources and can tolerate the risk, this may be a once in a generation opportunity to buy stocks this cheaply. It is also likely to be one of the worst possible times to be selling. We know this has not been an easy time to be invested in U.S. stocks. Though it is human nature to do so, try not to dwell on what has already happened. Instead, focus on the opportunities that we believe are being created. If you can do that and the market rebounds, you may soon enjoy stock returns that will feel like "Yours is the Earth, and everything that is in it."

The stock market may be close to turning around.

International stocks fared worse than U.S. stocks

The numbers are stark. The broadest measure of international equity returns, the MSCI All-Country World index (net dividends) declined by -21.9% for the quarter, in U.S. dollar terms. This was the largest such quarterly decline in the history of this index. Based on MSCI indices, emerging markets fell about -26%, while the developed markets declined about -20%.

Although the financial crisis began in the U.S., the losses have generally been greater overseas. In addition, the dollar has been stronger throughout this crisis, further undermining returns in foreign shares to U.S. investors. Over the past twelve months, Morocco was the only one of the 48 markets we cover to have a gain in U.S. dollar terms. But even in local currency terms, only a handful of developed markets outside of North America have fallen less than -20% over this period. Among the emerging markets, the largest and most liquid stock markets have generally fallen the most. Until confidence is restored in the U.S. financial system, it is difficult to see equities around the globe advancing again.

Valuations are attractive

Once this liquidity crisis is over, fundamentals again will matter and, from this perspective, the picture is much less dire. Growth is likely to continue to slow overseas. However, international stock valuations are extremely attractive by almost any measure. At quarter end, many core European stocks were trading at prices of only 1 to 1.5 times their book value. Yields reached 5.3% in the Netherlands, 7.1% in Italy and 9.2% in Belgium. In addition, price earnings multiples have fallen to extremely cheap levels.

The importance of emerging markets has increased in the last several years, as returns there outpaced those in the developed markets and new public offerings increased. However, it

is useful to put this into perspective. Global emerging markets reached a peak of about 11% of global stock market capitalization in mid-2007 from a low of just over 4% in 2002. But, looking back to the 1990's, prior to the Asian financial crisis, emerging markets reached almost 12% of global market capitalization. The proportion of global earnings coming from these markets now is far greater than in 1995.

Emerging market fundamentals look good

While returns in the emerging markets are currently lagging those of the developed markets, the less developed countries' underlying fundamentals are looking much stronger as inflation concerns have moved to the sidelines. According to our analysis, these markets have some of the greatest liquidity and growth prospects. When these fundamentals once again become the market's focus, we believe the opportunities and returns here should outstrip the major developed markets. An exception may be Russia, which is becoming an increasingly problematic country for investors due to continuing concerns about corporate governance and independence from the government.

With the global crisis focused on the finance sector, there is a great likelihood that, when stability can be restored to the lending markets, the other major sectors will thrive again. For now, all market participants are caught in the same downdraft. Through a variety of market and regulatory mechanisms, countries, sectors and investors should each gradually find protection from the storm and the opportunity to reap the rewards of the underlying fundamentals.

International stock valuations are extremely attractive by almost any measure.

Commercial real estate continues to be hurt by the credit crisis

The lack of transaction volume has made it challenging to determine pricing.

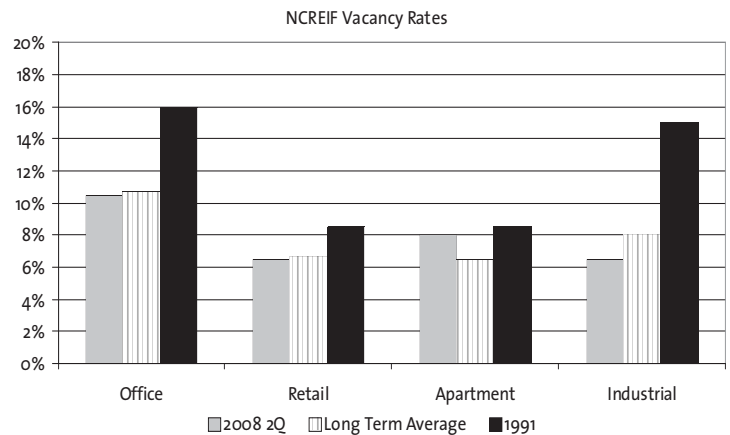
Like other asset classes, real estate is suffering from turmoil in the capital markets as a result of the credit crisis. While not the cause of the crisis, it is not surprising that commercial real estate has been one of the victims given the role of debt in this asset class. As the credit markets became consumed by fear in 2007, the market for commercial mortgage-backed securities (CMBS) evaporated. In 2007, CMBS issuance totaled approximately \$230 billion; year-to-date in 2008, issuance has been just \$12 billion. With the CMBS market closed indefinitely, a substantial portion of usually available debt capital is missing from the commercial real estate market. In addition, banks' reluctance to lend and tremors among the life insurers have further depleted the availability of debt financing in 2008.

What has been the result? Sales transaction volume is down year over year - anywhere from 55% to 70% depending on the property type. This is due in part to the difficulty of obtaining acquisition financing. The lack of transaction volume has made it challenging to determine pricing in this fluid environment. Recent data would seem to indicate that cap rates are up anywhere from 10 to 50 basis points (bps) (0.1% to 0.5%) in the last year, although Central Business District office cap rates actually show an unlikely decline of 24 bps (0.24%) since the second quarter of 2007. Until debt again becomes available, there is unlikely to be any resolution to the uncertainty in commercial real estate or a solid indication of where market clearing prices actually are. Furthermore, as the uncertainty wears on, continued upward pressure on cap rates (and downward pressure on pricing) is likely as many buyers wait it out on the sidelines.

Commercial Real Estate Fundamentals

There is some good news, and that is our starting point going into this period of extreme uncertainty. Both supply and demand fundamentals in commercial real estate are healthy today in most markets (with a few notable exceptions). This general market equilibrium can be contrasted with the supply bubble of the early 1990's, when vacancy rates were elevated prior to the downturn. As Chart 2 indicates, current vacancy rates for the major property types, while slightly above their 2007 low points, are generally hovering around the long-term average and are well below the highs reached in 1991. Vacancy rates have not exploded in part because a sharp increase in construction costs restrained supply growth during the recent expansion.

Chart 2



Source: National Council of Real Estate Fiduciaries (NCREIF)

On the demand side, commercial real estate has not experienced the speculative leasing of space by tenants that characterized the demand bubble of the late 1990's and drove the subsequent commercial real estate downturn earlier this decade. Having learned from past mistakes, tenants have been reluctant to lease additional space through this past upswing, leaving many with too little space to meet their existing needs.

The relative balance of supply and demand has

Commercial real estate continues to be hurt by the credit crisis (continued)

provided growing income at the property level. Even through the second quarter, net operating income growth on a trailing twelve-month basis was a healthy 4.5%. Income growth has allowed properties to continue to service debt, resulting in a lack of financial distress to date. Current commercial real estate loan delinquencies are just 0.51% , compared to 2.0% in 2003 and closer to 8.0% in the early 1990's. Again, with the benefit of some perspective, it would seem that commercial real estate is well positioned at this point in the cycle relative to past downturns.

What Happens from Here?

Going forward, commercial real estate is certainly not immune to the overall economy; it is very much a cyclical asset class. We expect to see downward pressure on property-level incomes as the impact from lower consumer spending and job losses is felt. However, a diversified commercial real estate portfolio can help to mitigate the impact of a cyclical downturn by providing exposure to lower volatility property types and relatively long lease terms.

It is also important to bear in mind the key benefits of commercial real estate within a multi-asset portfolio - relatively high income, low volatility and low correlation with other asset classes. Based on research done by Bailard's Ron Kaiser and the performance of NCREIF National Property Index since its 1978 inception, commercial real estate has only had three negative years from 1934 to 2007. In the worst of those 74 years, commercial real estate returned -6.1%. This compares very favorably to the performance of other asset classes during that time period.

We believe the turmoil in the markets, while unnerving, represents an opportunity for attractive acquisitions going forward. In addition, the current dislocation in the debt markets coupled

with tighter lending standards should continue to put a damper on new construction, which is a positive for commercial real estate.

A diversified commercial real estate portfolio can help mitigate the impact of a cyclical downturn.

We reduced our international stock exposure during the quarter

Avoiding emotional overreactions is important to investors' long-term returns.

The third quarter started off like the second quarter, with the stock market moving higher and rising hopes we had put the worst behind us, only to be disappointed. In September, as the global equity markets broke to new lows and the dollar strengthened, we reduced our international exposure to a neutral position. In our domestic stock portfolios, we reallocated assets from large cap stocks to small cap value stocks. Historically, small cap tends to outperform other equity styles in the latter stages of bear markets and to lead coming off the bottom.

U.S. Stocks: Overweight

The performance of stocks over the last quarter and the last year has been extremely disappointing and frustrating for stock investors. In hindsight, our overweight position in equities has been unambiguously wrong (see the interview portion of this newsletter). This is why we maintain a diversified posture at all times and don't drift too far away from our long-term strategic norms. Unfortunately, this has also been a period where all asset classes outside of the safety of U.S. Treasury debt have struggled, thereby failing to provide the normal offsets to weak stock returns.

Although it is difficult to do, maintaining discipline and avoiding emotional overreaction is important to investors' long-term returns. We see current stock valuations as table pounding buys, with P/E multiples of close to 10 times earnings (a level last seen in the high inflationary 1970's). Given low inflation and interest rates, we believe P/E multiples should be much higher. While it is impossible to call a bottom, historically after declines of this magnitude, stocks tend to come back sharply. Bear markets set the seeds for the next bull market, with investors moving heavily to cash that can later be used to make investments. Today, investor sentiment is extremely negative and a moun-

tain of cash has built up on the sidelines. Any hint of stabilization in the banking system and economy could bring a flood of cash back into the market. We strongly advise patience and believe investors buying stocks today will be more than amply rewarded.

International stocks: Neutral

International stock valuations look as attractive as those of U.S. stocks, with developed country P/E's at 10 times earnings on average and emerging country P/E's at 8 times earnings. Until the U.S. market rebounds, the foreign stock markets will likely remain under pressure. We are looking for the dollar to stabilize before we move back to an overweight position in this asset class.

Global Bonds: Underweight

Outside of Treasury debt, the bond market has been weak, with credit spreads widening out to record levels. However, with Treasury bill yields at 0.30% and ten-year Treasury bond yields at 3.4%, the Treasury market is extremely overvalued. When the economy turns, Treasury yields will likely climb and the loss of capital could be significant. This is a point in time when the safety of Treasuries could prove to be illusory.

Real Estate: Neutral*

Cyclical fundamental deterioration in the commercial real estate sector will probably limit appreciation over the next year. Vacancy rates are slightly rising across property types, non-residential construction activity is growing at a 16% annualized rate, and bank willingness-to-lend is declining. Real estate is facing the same cyclical pressures felt by other assets. Nevertheless, the long-run fundamentals remain intact, and we see real estate as a solid portfolio diversifier going forward.

We reduced our international stock exposure during the quarter (continued)

Alternative Assets: Neutral*

The recent financial market turmoil reinforces our belief in using alternative assets to offset the risk inherent in our equity portfolios. Given the lack of yield in the money markets, for suitable investors, we would prefer alternative assets such as long-short portfolios geared to reducing volatility as an alternative diversifier.

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

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U.S. INTEREST RATES

	12/31/2007	3/31/2008	6/30/2008	9/30/2008
Cash Equivalents				
90-Day Treasury Bills	3.25%	1.33%	1.74%	0.92%
Federal Funds Target	4.25%	2.25%	2.00%	2.00%
Bank Prime Rate	7.25%	5.25%	5.00%	5.00%
Money Market Funds	4.59%	2.85%	2.23%	2.25%

Bonds

30-Year U.S. Treasury	4.45%	4.29%	4.53%	4.31%
20-Year AA Municipal	4.38%	4.79%	4.64%	5.14%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US\$) THROUGH 9/30/2008

	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	2.31%	5.14%	10.41%
Merrill Lynch 7-10 year Agency Index	1.08%	2.12%	6.35%
Merrill Lynch 5-10 year Corporate Index	-8.63%	-9.61%	-7.82%
Lehman Bros. Municipal Bond Index	-3.21%	-3.19%	-1.87%

International Bonds

Citigroup non-U.S.\$ World Government Bond Index, fully hedged	2.66%	2.37%	4.36%
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Sources: Bloomberg L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US\$) THROUGH 9/30/2008

	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-3.71%	-16.57%	-19.84%
S&P 500	-8.36%	-19.27%	-21.96%
NASDAQ 100	-13.10%	-23.25%	-23.36%
S&P SmallCap 600/Citigroup Value	2.33%	-6.62%	-13.03%

International Stocks

MSCI Japan, net dividends	-17.65%	-22.21%	-26.93%
MSCI Europe (includes UK), net dividends	-20.77%	-30.60%	-30.93%
MSCI EAFE (Europe, Australia, Far East), net dividends	-20.56%	-29.26%	-30.50%

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

REAL ESTATE TOTAL RETURNS (US\$) THROUGH 9/30/2008

	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	0.56%	2.74%	6.04%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is an estimate.

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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the 9:05 is published four times a year by Bailard, Inc., 950 Tower Lane, Suite 1900, Foster City, California 94404-2131 (650) 571-5800. www.bailard.com. Publication dates vary depending upon the availability of critical data, but usually fall in the first month of each new quarter.

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