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A Quarterly Review of Economic and Market Developments

4TH QUARTER 2008

BAILARD INTERVIEW

Opportunities After A Year Of Extremes

Bailard's Chief Investment Officer Sonya Thadhani reflects on the 2008 bear market and some of the investment opportunities it has created.

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Most investors would like to forget 2008 ever happened. How would you describe this very painful year?

I'd call it a year of extremes that witnessed a radical repricing of financial assets. 2008 was the worst year for the global equity markets in the post-World War II period. Investments in U.S. and international stocks saw precipitous declines in value as the financial crisis spilled over into the real economy. In the U.S., major market index returns ranged from -30% to -42%, depending on the size and style of investing. Things weren't a lot better outside the country. The best performing developed market internationally was Japan, whose Nikkei Index returned -30.5% for the full year in U.S. dollar terms. World markets lost approximately half of their value on average and the range of losses went from -30% to -75%.

Fixed income returns weren't as homogeneous. U.S. Treasury bonds performed very well for the year, mainly due to investors' extreme risk aversion. As equities earned pariah status in the middle of September, government bonds gained in popularity. For the full year, according to a Merrill Lynch index, U.S. Treasuries returned 14%. On the corporate and high yield end of the fixed

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Opportunities after a year of extremes (continued)

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income spectrum, however, returns weren't as rosy. The Merrill Lynch High Yield index fell -26% for the year amidst grave concerns about the ability of corporations to borrow money and remain in business.

Bear markets often create investment opportunities.

2008 also saw the Chicago Board Options Exchange Volatility index (VIX) reach an all time high of 80.9 on November 20, 2008 after starting the year at 22.5. This index, which began in 1993, is based on the price movements of various options on the S&P 500 index. It has become an increasingly popular measure of investor anxiety, hitting its highest levels during times of investor turmoil and fear. 2008 ended with the VIX falling dramatically to 40.0, 50% below where it was in November but 78% above its level at the beginning of the year.

Yields on U.S. Treasury bills reflected the same extremes in investor sentiment. The 90-day Treasury bill started 2008 with a yield of 3.13% and ended the year with an essentially zero yield of 0.03%. The concept of risk became more and more unpalatable to most investors as the year progressed. This caused a flight to safety that led investors to be willing to be paid basically nothing for making short-term loans to the American government.

Finally, high yield corporate bond spreads (i.e. the difference between the yields on high yield corporate bonds and the yields on U.S. Treasury bonds) also entered into uncharted territory in 2008. Over the long term, high yield bonds have historically traded at yields that averaged approximately 500 basis points (5.0%) more than the yields on U.S. Treasury bonds. As the credit crisis burgeoned in the fall of 2008, corporate spreads widened to a bit more than 2000 basis points (20.0%) over Treasuries.

So, to call 2008 a year of extremes would be appropriate.

Bear markets often create investment opportunities for those with the risk tolerance to take advantage of the radical repricings caused by a climate of fear. What opportunities, if any, do you currently see within the domestic equity markets?

The U.S. stock markets experienced broad declines over the course of 2008. No size category and no style escaped the selling. The broad based S&P 500 posted its worst year since 1931, the Goldman Technology index lost close to -44% (a worse showing than in either 2001 or 2002), and small cap value stocks lost -29.5% of their value as measured by the S&P Small Cap 600/Citigroup Value index. These sell-offs have reduced domestic equity valuations to very attractive levels across the board, leading us to continue to like the outlook for U.S. stocks generally.

However, we believe that microcap value stocks, which were one of the worst performing segments of the U.S. equity market in 2008, offer some of the best investment opportunities at this time. Microcap stocks are defined as being the smallest 1% of the entire domestic stock universe. The value segment is separated out from the growth segment of this universe based on valuation measures such as price/book. Although these stocks are inherently riskier and more thinly traded than the broader stock market, various studies have shown that, historically, the smallest stocks tend to be the best performers over the long run. Much of this is due to the fact that these stocks are under-followed and under-owned. Expectations are not high, making disappointments less likely.

The average microcap value stock today trades at less than 0.5x book value, and all microcap value stocks traded at below 1x book value at the end of 2008. Clearly, this market is discounting (i.e., pricing in) an "end of the world" scenario for the economy. The low valuations also reflect the difficulty many of the smallest companies are having in finding financing for their operations. Much of the recovery in microcap value stocks should occur when credit quality spreads begin to narrow. In a struggling economy, companies with cash needs that cannot afford or acquire the necessary funds to stay in business will most likely go out of business. However, as credit markets improve, we believe the return potential

Opportunities after a year of extremes (continued)

of this particular area within the stock market should be quite large.

Are there comparable investment opportunities within the international stock markets?

Similar to our markets at home, there was no country that did not experience a double-digit decline in equity returns in 2008. International stock valuations are also quite attractive. We believe investing in a basket of countries across the developed as well as the riskier emerging markets is the best way to gain international equity exposure going forward.

However, our analysis suggests the sell-off in 2008 has created tremendous opportunities in the emerging markets. Over the long term, much of the world's economic growth is expected to come from emerging markets. Beneficial demographic trends - particularly in India and China - should also help drive economic growth in these regions. While we believe investing in emerging markets should always be a strategic part of international investing, emerging markets' valuations are looking particularly compelling at this time. Developed markets, which have a negative near-term growth outlook, are currently trading at a P/E multiple of 9x next year's earnings. However, the emerging markets, which are still expected to grow positively (albeit at a slower rate) next year, have 7.5x earnings multiples. So strategically and tactically, we like the emerging markets at this time.

What about investment opportunities in the fixed income arena?

As I mentioned before, high yield corporate bond spreads are in uncharted territory. At their peak in 2008, high yield bond spreads were four times their long-term historic average. As credit spreads narrow to more normal levels, the prices of high yield bonds should increase. Yields do not even need to return to their long-term averages in order for a high yield bond strategy to score. Keep in mind that no high yield investment opportunity comes without risk. High yield bonds pay higher yields because of their issuers' low credit ratings. We will see bankruptcies and we will see defaults. However, from an historic perspective, high yield debt looks rather attractive right now.

Given these opportunities, should investors still be diversified over multiple asset areas?.

Our approach to investing is rooted in the principles of diversification. While diversification might not have led to positive returns in 2008, the very presence of non-equity investments in an asset allocation should have muted the downside. Low volatility assets are as important to an investment strategy's overall health and well being as high volatility assets are. The highs are never as high, and the lows are never as low with a diversified portfolio.

2008 has been unique in many ways. We see tremendous opportunities ahead within the broad asset areas. I've highlighted a few examples where extreme overreaction has caused some deep value in our opinion. Picking the date on which that value might be realized is a difficult, if not an impossible task to achieve. Moreover, each opportunity has its own unique risks. Emerging market stocks, for example, tend to be more volatile, more thinly traded and more vulnerable to expropriation and national instability than their developed market counterparts. But positioning a portfolio to take advantage of some of these opportunities can offer potentially exciting rewards to investors for whom these investments are appropriate.

Microcap value stocks, emerging market stocks and high yield debt look rather attractive right now.

The U.S. economy fell off a cliff in the fourth quarter

We expect the economy to be weak before regaining its footing in the second half of the year.

The U.S. economy fell off a cliff in the fourth quarter of 2008 as financial panic and the seizing up of the credit markets brought economic growth to a screeching halt. GDP in the fourth quarter is likely to be reported down -4.0% to -6.0%. We expect the economy to be weak during the first half of 2009 before regaining its footing in the second half of the year.

If our forecast is correct, U.S. economic numbers will remain disappointing in the near term. However, since investors tend to look forward, the financial markets should begin to recover long before we see any improvement in the economic indicators. History shows us that market bottoms are made on bad news not good. When most people think the worst is yet to come, that risk is usually already priced into stock market prices.

We are already seeing investors' appetite for risk begin to increase. As of this writing, global stock markets are 20% to 30% off their lows. The VIX and other measures of market volatility have fallen sharply. Some key short-term interest rates (like Libor and commercial paper interest rates), after spiking higher in September and October during the worst of the credit crunch, have returned to normalcy. Credit spreads have also begun to narrow as investors are moving to lock in record high yields relative to U.S. Treasury debt. Finally, bank lending is beginning to expand.

Make no mistake, investors are still cautious. We fully expect the financial markets to remain skittish given the recent shock to investors and the likelihood of continued bad economic news in the near term. However, investors' "animal spirits" appear to be stirring and there is light at the end of the tunnel. We believe a lot of risk is still priced into the markets. We also believe that the preconditions for a modest economic recovery in the second half of 2009 are already in place.

Preconditions for Growth

Monetary Policy: The Fed has lowered the Fed Funds Rate and is targeting a range of 0% to 0.25%, effectively pursuing a "zero interest rate" policy. In addition, the central bank has explicitly stated a willingness to keep rates in this range for as long as necessary. The Fed has implemented a series of lending facilities to provide liquidity directly to a number of institutions and markets (banks, brokers, money market funds, foreign central banks and providers of asset backed consumer and business credit). It is also beginning to purchase longer term U.S. Treasury, government agency and high quality corporate debt in an effort to reduce long-term mortgage and corporate borrowing costs. As a result of all of these efforts, liquidity is being restored to the financial system. Bank reserves, currency in circulation and broader monetary aggregates are growing rapidly. We will know that the reliquification process is working if credit spreads continue to narrow and (most importantly) bank lending continues to reaccelerate.

Housing Affordability: A stabilization of the housing sector is an important prerequisite for economic recovery. One indication that the government's actions are gaining traction is the sharp decline in conforming mortgage rates (rates on smaller federal housing agency loans) that has occurred over the last couple of months. More recently, even jumbo mortgage rates on loans above $625,000 have started to decrease. Last year, housing affordability improved because home prices were declining; now affordability is improving because mortgage rates are falling. Housing affordability (the ability of a median income household to afford a median priced home) moved to record levels in the fourth quarter. After three years of a housing recession, there is a growing backlog of pent–up demand for homes. Tighter lending standards at banks and job security concerns will continue to hold back many potential buyers from purchasing homes. But even here the news seems to be improving, as mortgage applications have surged. Mortgage applications for home purchases have risen 23% from the October low, while applications for refinancing are up a stunning 528%.

The U.S. economy fell off a cliff in the fourth quarter (continued)

Oil Prices: Last June, we argued that the high price of oil was an unsustainable bubble driven by speculative fever and predicted that, like all bubbles, it would eventually end in a bust. The drop in oil prices was much faster and sharper than we envisioned due to the dramatic slowdown in the U.S. economy in the fourth quarter. The lower oil prices are a big relief to consumers and most businesses. Given that the U.S. consumes eight billion barrels of oil a year, the $100 per barrel decline in oil prices is equivalent to a $800 billion tax cut and provides a big boost to purchasing power.

Fiscal Policy: Fiscal policy has been expansionary over the last year, with the Treasury reinforcing the Fed's attempts to stem the financial crisis. Although the Treasury's $700 bailout plan has experienced a bumpy road, it appears to be working. The Obama administration is also planning to pump an additional $750 billion to $1 trillion of fiscal stimulus (over two years) into the mix. It is likely to include a combination of tax cuts, infrastructure spending projects and assistance to state and local governments. Whether or not this stimulus program is necessary is debatable, but it is coming and will be a big insurance policy for the economy.

The structure of the plan is also important. If the money is going to be spent, it can be spent in a way to provide a long-term boost to growth or it can be used to provide a temporary fix. Tax cuts that are permanent, such as President Obama's "Make Work Pay" campaign proposal (which would provide a permanent $500 per individual or $1,000 per working family tax credit), would likely be more beneficial than a temporary one-time check like last year's "rebate" checks. Everything else being equal, temporary tax cuts have only a short-term impact on growth, while permanent tax cuts impact the long-term growth potential of the economy. Similarly, infrastructure spending that is geared to renovating and upgrading essential services (such as the electrical grid and the highway system) would provide a long-term benefit to the economy as opposed to bridges to nowhere and teapot museums. While state and local governments are under distress, loans rather than direct payments would be a more fiscally sound approach.

Outlook for Recovery

Although the U.S. economy is not out of the woods yet and the severity of the financial meltdown could make things different this time, history is on our side. Most recessions end with an aggressive expansion of monetary and fiscal policy. Historically, when massive amounts of money are made available at low rates, economies and markets tend to respond favorably. Given the record high in housing affordability and the boon from falling oil prices, we believe the preconditions for growth are in place.

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International economic growth also plummeted in the fourth quarter

Although the global economy is not yet out of the woods, problems are being aggressively addressed.

On September 15, 2008, the Monday after Lehman Brothers failed and Merrill Lynch was taken over by Bank of America, credit markets everywhere froze, sending the international economies off a cliff along with that of the U.S. Since then, exports and manufacturing have declined around the world. The JPMorgan Global Manufacturing PMI (Purchasing Manager Index), an average of all available national PMIs, has fallen to 33.2, its weakest reading on record. Readings below 50 indicate slow economic growth, while readings below 42 indicate a recession. The Global PMI fell every month during 2008 but accelerated to the downside in the fourth quarter. Almost all national GDP, industrial production, retail sales, housing and employment reports have weakened. Even China has seen a slowdown in GDP growth, albeit from a very high level to 8% or 9% year over year.

Initiatives to Stimulate Growth

Like the U.S., foreign nations are adopting initiatives to reverse the economic slide. Monetary policy has been dramatically eased, with overnight rates dropping sharply everywhere. Rapidly falling inflation has given central bankers free rein to boost their economies: the U.K., Australia Canada, Japan, China and India are all in serious easing modes. Even the European Central Bank (ECB), which had been in deep denial about economic conditions, has begun to cut rates.

In addition to aggressively easing monetary policy, many countries are pursuing a more stimulative fiscal policy by cutting taxes, increasing spending and providing government guarantees for bank deposits. For example, Japan has proposed a 6.6% increase in spending for 2009 and delayed implementation of new consumption taxes. Korea has announced a $32 billion infrastructure building plan. Europe has initiated a $164 billion stimulus package to support that region's economy.

While the U.S. is leading the economic recovery efforts in the West, China is heading the charge in the East. The People's Bank of China has cut interest rates five times since September, reduced the reserve requirement on bank deposits and lifted lending restrictions on banks. Beijing has also announced a $580 billion fiscal stimulus package over the next two years. Given the relatively smaller size of China's GDP, this is equivalent to about a $2.5 trillion stimulus in the U.S. In addition, China is lending money to its Asian neighbors, helping to alleviate the region's liquidity squeeze and building regional trade ties. Beijing has also allowed the resumption of direct flights between the mainland and Taiwan. Equally important, China is not retrenching and moving back to isolation. Instead, it is fulfilling its role as a regional and global economic leader.

Outlook for Recovery

As with the U.S., although the global economy is not yet out of the woods, its problems are being aggressively addressed. Our base scenario is for the global economy to recover albeit modestly along with the U.S. in the second half of this year. Since markets tend to anticipate economic developments, we would expect stocks to begin to recover long before that.

A flight to safety pushed non-Treasury yields to historic highs

The fourth quarter saw an intensification of the "flight to safety" theme that dominated the U.S. bond markets during the third quarter. The same theme generated the same results – a strong bid for risk-free Treasury debt and a disdain for anything that exhibited any level of risk. While the third quarter generated what was, up until that point, the worst return to high yield bonds in that sector's history (-9.5% as measured by the Merrill Lynch High Yield index), the fourth quarter set a new benchmark when the index fell -17.5% for the three months. At the same time, Treasury bonds exhibited some of the best returns in the past 30 years during the fourth quarter. The Merrill Lynch Treasury Master index for the Treasury market as a whole returned 9.0%, even as the Merrill Lynch 10+Year Treasury index for long-dated Treasuries rose 18.9%. Overall, the broad domestic bond markets posted a healthy 5.1% return for the fourth quarter, as measured by the Merrill Lynch U.S. Corporate, Government and Mortgage index.

Historic Yield Spreads

All this left the credit markets in a pretty remarkable position. By year's end, the 30-year U.S. Treasury bond yield at 2.7% was near its lowest level in history, while yields on shorter maturity Treasury bills were essentially non-existent. At the same time, corporate yields had ballooned to levels that implied a risk of immense future defaults. Chart 1 shows the widening of high yield spreads that occurred in 2008. At year's end, high yield debt was, on average, yielding 18.1% more than Treasuries after peaking at a spread approaching 20%. Investment grade debt was trading at 6% more than Treasuries, a level more typical of junk bonds.

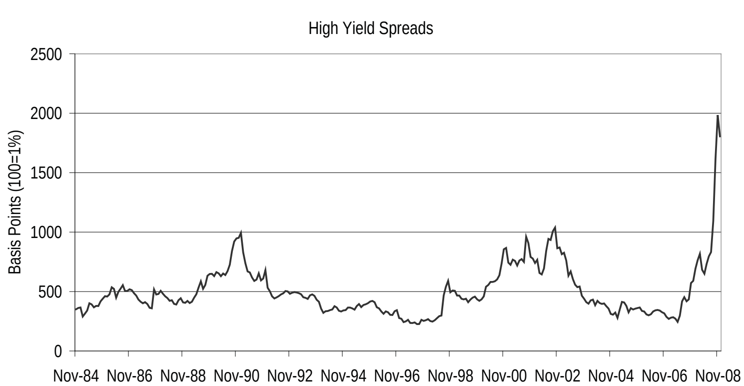
Although today's high yields make corporate bonds look very attractive, several caveats must be observed. Since the economy is in a recession, we will undoubtedly see a large number of corporate defaults in 2009. This process will be exacerbated by two structural issues. First, in recent years, many companies raised capital with direct bank financing through the collateralized loan market. This debt is senior to that issued in the public markets, limiting the potential recovery rate for corporate bondholders in bankruptcy situations. Secondly, companies with Chapter 11 filings often rely on bank-provided debtor-in-possession financing and other tools to bring them back to solvency. Although bank lending is beginning to increase, given the ongoing credit crunch, it is unclear if banks will be willing to provide an adequate amount of this speculative lending to these corporations.

Municipal Debt

The municipal market experienced similar dislocations to that of the corporate bond markets in 2008. Yields skyrocketed as fears of local and state budget imbalances increased along with the risk of insolvency for traditional bond insurers. Municipal yields have reached unprecedented levels, with high grade issuers paying more than Treasury yields across the maturity spectrum. Historically, defaults in municipal debt are much rarer than their credit ratings imply. This is even more true when it comes to state general obligation debt (which has never defaulted, even during the Great Depression) and essential purpose utility bonds.

That said, the situation for many states, especially California, is pretty bleak. Regardless of rhetoric, most states have little ability to substantially reduce spending.

CHART 1



Source: Bloomberg, LP (Month-end data)

A flight to safety pushed non-Treasury yields to historic highs (continued)

The greenback's recent strength is most likely a short-term reversal within a longer term trend of dollar weakness.

Tax revenues are falling off sharply due to slower retail sales, more foreclosed properties, lower incomes and less capital gains. As a result, many states may be forced to raise taxes, at least in the short-term. While higher taxes are not desirable in a recessionary environment, they are preferable to municipal defaults.

FOREIGN EXCHANGE

The fourth quarter for the foreign exchange markets was eerily similar to the third quarter. Currencies that represented safe havens outperformed as risk aversion continued to increase. During the fourth quarter, the best performance came from the Japanese yen and the Swiss franc, which advanced 17% and 5%, respectively, versus the U.S. dollar. All other major currencies in the world fell relative to the greenback. The U.S. dollar retained favor with global investors in spite of weakening local conditions.

During the quarter, the Fed reduced short-term rates essentially to zero and began looking at measures of quantitative easing, such as the out-right purchase of long-term Treasury debt. The U.S. is not alone though. It is more likely paving the way for other central banks to make similarly aggressive easing moves. The Bank of England appears ready to lower the Bank Rate to its lowest level since the bank's creation more than three hundred years ago. After raising rates as recently as July, the ECB finally realized the urgent need for increasing liquidity and lowered rates three times during the fourth quarter from 4.25% to 2.5%. Nevertheless, short-term interest rate differentials are likely to favor foreign currencies over the dollar, as the U.S. will probably experience negative real interest rates due to quantitative easing.

Weaker Dollar in the Longer Term

The U.S. dollar benefited from investors' flight to safety during the second half of last year. As the financial crisis stabilizes and investors are more willing to take risks, the currency markets are likely to shift their focus from safety concerns to such fundamental as interest rate differentials, which favor other currencies. So the greenback's recent strength is most likely a short-term reversal within a longer term trend of dollar weakening.

From a fundamental standpoint, the yen is likely to be the strongest currency versus the dollar, although most Asian currencies are currently undervalued. We believe the greenback will be less weak relative to the euro.

U.S. stocks experienced one of their worst years ever

In the fourth quarter of 2008, U.S. stock market returns went from bad to terrible. The S&P 500 plunged -22.0% for the quarter, ending 2008 down -37.0%. The NASDAQ 100 fared even worse, down -23.9% for the quarter and -41.6% for the year. Worst for the quarter but best (or least bad) for the year were small cap value stocks. As measured by the S&P Small Cap 600/Citigroup Value index, this segment of the U.S. stock market fell -24.5% in the quarter, but -29.5% for the year.

2008 was not just a bad year for domestic stocks, it was one of the worst years ever. Going back to 1926, the S&P 500's 2008 decline of -37.0% was the second worst calendar year return on record. The fourth quarter's decline of -22.0% was the seventh worst quarter on record, and the worst since 1987.

Reasons for the Decline

What caused such a precipitous drop in stock market prices? The financial crisis worsened significantly in the second half of September, spilling over into the real economy in a way it had not done before. The government's response to the crisis at times appeared confused, home price continued to weaken, and consumer confidence plummeted going into the holiday season All of this conspired to drive what amounted to a stock selling panic.

The news media did its part as well, focusing and dwelling on every scrap of bad news. As anyone who has ever witnessed news coverage in action can attest, the camera will be focused on the house with the torn awning when there is a hurricane story, and not on the ten houses surrounding it that were undamaged.

At the end of the third quarter, we felt that a turnaround in the stock market was approaching. We were clearly too early in looking for light at the end of the tunnel, but the light is there, and there are several reasons to think that it is getting brighter.

Reasons for Hope

Although past performance is no guarantee of future results, history shows that, after a large negative quarter, the stock market on average rises substantially over the following year. Since 1926, whenever the S&P 500 has declined more than -15% in a quarter, the average gain one year later has been 17%. If we look at the modern era (since WWII), the average gain one year out has been 22%.

The liquidity crisis that precipitated the current bear market appears to be starting to resolve itself. Government action, though not as nimble or as focused as we would have liked, has been successfully pumping money into the financial system. This is the polar opposite of what happened in the Great Depression, when the money supply substantially contracted. As a result, banks' reluctance to lend appears to be lessening, which should pave the way for economic expansion. A reliable measure of banks' willingness to lend is the credit quality spread between the yield on below investment grade bonds and Treasury bonds. At its widest point in December, this spread reached a record 21.8%. As of early in 2009, this spread has narrowed substantially to a still wide 16.4%. This is strong evidence that credit is beginning to be made available again, which should support increasing stock prices as fear abates.

Valuations, which were already low last quarter, are even lower now, and at historically very attractive levels. The S&P 500, at 12x trailing earnings, is incredibly cheap given how low interest rates are currently. Smaller capitalization stocks are even cheaper, in many cases selling below tangible book value. If the world does not end here, the upside potential to stocks from today's valuation levels should be substantial.

Finally, the U.S. stock market has stopped declining. It bottomed on November 20th and actually rallied 20% going into year-end. While further testing of the lows is certainly possible, the panic selling witnessed earlier in the quarter appears to be over.

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International stocks experienced double-digit losses

The run of great returns for international equity investors came to a grinding halt in 2008.

The fourth quarter of 2008 was an extremely difficult period for international stocks. The broadest measure of global returns, the MSCI All Country World ex-U.S. index (U.S. $, net dividends), fell -22.3% for the three months as financial panic and fears of recession spread around the world.

As a result, the run of great returns for international equity investors, dating back to 2002, came to a grinding halt in 2008. The MSCI All Country World ex-U.S. index (U.S. $, net dividends) fell -45.5% for the year. Emerging markets fared even worse, with the MSCI Emerging Markets Free index falling -53.3% in U.S. dollar terms. In fact, there was nowhere to hide. None of the 48 major markets around the world turned in positive results for the year. Only one country managed to fall less than -25% in dollar terms. Moreover, it was almost impossible for investors to take advantage of differences in returns among markets, since the spread of returns from the worst of the first quartile to the best of the fourth quartile was only 15%. In an environment where fear drove all markets down without discernment, investors had few opportunities to find safe havens among the world's equity markets.

Government Indebtedness to Increase

The crisis has exposed weaknesses in government, corporate and banking balance sheets. The financial leverage that propelled growth around the world during the first years of this century has become the engine of our global recession. Governments' indebtedness coming into the crisis was rather benign, but is likely to rise dramatically as a tool in guiding us out. Estimates for U.S. Treasury borrowings are currently topping $2 trillion. Similar stories are true across much of the developed world.

Increasing deficits as tax revenues decline and fiscal demands increase will likely hamper some countries' abilities to inject sufficient stimulus. This may be especially true in the European Union, where the Maastricht criteria spell out strict guidelines for budgetary deficits. China, Korea and Singapore are probably best positioned to stimulate their economies. At the other end of the spectrum, Hungary, Indonesia and the Philippines began this crisis with much less policy and financial flexibility.

Impact on Emerging Markets

We expect the crisis to have differential effects on emerging markets countries based on their vulnerabilities, the scope of the policy tools available to them and their success in actually implementing the policies. For many of these markets, the real crisis comes in the form of declining growth rates of trading partners. For markets dependent on the U.S. and Western Europe, the lower demand for foreign goods could reduce GDP by 2% to 2.5%. Countries that are dependent upon remittances of workers abroad will also experience greater difficulties. Finally, countries with high loan-to-deposit ratios are vulnerable to international creditors demanding a return of liquidity. Here, the Eastern European markets appear most at risk as their currencies fall in relation to their euro-denominated debt.

Increased Dispersion in Returns

The level of fear in the markets during 2008 is unlikely to continue into 2009. Already, some measures of investor anxiety - such as the VIX index and corporate credit spreads - have begun to show hints of a return to rationality. As a result, there is an increased probability of a greater dispersion of investment returns around the globe as investors focus on the underlying economics of the markets and the health of the corporations within. This greater dispersion should translate into increased opportunities to add value by selecting among markets overseas.

The outlook for commercial real estate is rapidly changing

In this quarter's newsletter, it is customary to expect our outlook for the year ahead. Normally, commercial real estate trends are relatively easy to forecast compared to most other areas of equity investment. Occupancies and rents change slowly over time, and indications of overbuilding problems often emerge before properties are completed. Prices tend to change only gradually, and historically have usually moved in one direction—up! (Over the past 71 years, our research has shown only three negative return years for commercial real estate, on a national average.)

Everything is different now. The trend has changed, and market conditions are rapidly changing. Debt capital is almost non-existent, leaving most players frozen in their tracks. As a result, only those who need to sell are in the selling market, and they are generally seeing downward pricing pressure. The NCREIF National Property index (NPI), which will not be released until after this newsletter goes to press, may well show a negative return for 2008.

Appraisals Are More Difficult

In this environment, appraisals involve more judgment than normal. It is not necessarily appropriate to price all properties in a portfolio based on what a few sellers are under pressure to accept at margin. In hindsight, such pricing may very well prove to have been unreasonably low "outliers." We simply do not have very many transactions involving willing buyers and willing sellers anywhere in the country on which to base property appraisals. Thus, it may well take a few more quarters to get a stabilized picture of commercial real estate pricing.

Further adding to the deterioration in property values is the downturn in occupancies and rents that is just now emerging. As the U.S. economy slides further into recession, businesses are cutting back rather than expanding. Some retailers are going bankrupt. These trends represent potential real problems for investors in financial center office buildings or in shopping malls. Even apartment rents are beginning to soften a bit, though this property type is likely to continue in its role as a portfolio stabilizer. Fortunately, none of the major commercial property types were as severely overbuilt at the outset of this recession as they were in the late 1980's.

Some Recommendations

With forecasting so difficult, we offer four recommendations for dealing with this environment, at least until lenders begin to return to the commercial real estate market:

- Stay diversified, but limit exposure to office buildings and to retail centers.
- Don't sell good properties if it's not necessary. You'll probably regret such sales once this crisis is over.
- Keep working capital available to see properties through the vacancy and re-tenanting costs they are likely to have to endure. It will be nearly impossible to get a lender to help with these expenses for a while.
- If you have cash to invest, start shopping for quality properties. You might be surprised at the prices some sellers will accept.

In next quarter's newsletter, this column will provide an in-depth analysis of the 2008 NCREIF NPI return data, and perhaps offer a clearer view of the coming year.

It may take a few more quarters to get a stabilized picture of commercial real estate pricing.

U.S. and international stocks look quite attractive

2008 was obviously a challenging year from both an economic and a financial market perspective. It was also a great reminder of how humble one should be about the ability to predict extreme outcomes and how important it is to stick to a long-term diversified investment strategy. In engineering, chemistry or cooking, if you follow the plan, formula or the recipe, you can reasonably be assured of the outcome. Unlike these occupations, investing must deal with the added factor of human emotion, which makes outcomes much less certain. Uncertainty about the future is one of the reasons we do not make heroic bets around the long-term strategy and always maintain a diversified posture. While no one likes negative returns of the magnitude we saw last year, there were few places to hide and diversification did mute the downside. Holding cash, alternative assets, real estate and bonds did provide some cushion against the losses in the global equity markets.

Moving forward, it is important to realize that investments have no past only a future. Investing through the rear view mirror is just as dangerous as driving through the rear view mirror. Oftentimes, the best opportunities are where capital is fleeing and the worst prospects are where we have been.

Table 1 on page 13 highlights our projections for the long-term (five year) return prospects for the various asset classes. The table indicates the starting yield for each asset class, its growth prospects and the potential for upward or downward shifts in valuation. Over the last year, we saw a large repricing in the relative attractiveness among asset classes, which provides an unemotional starting point to help guide us going forward.

Global Bonds: Underweight

Government bond yields fell precipitously last year as a flight to safety drove them to record lows. Investing in an asset with a less than 2.5% starting yield, with no potential for growth in its income stream and a high risk of downward valuation does not seem like a wise strategy to us. While yields could drift lower in the short term, over a longer term horizon this is likely to be a bad bet. With yields this low, government bonds should be more sensitive to shifts in interest rates, making them a riskier than normal investment. The higher yields of corporate and municipal bonds make them much more attractive. However the economic conditions that would drive corporate and municipal yields lower would most likely drive stock prices higher too.

U.S. Stocks: Overweight

Because of the sharp decline in stock prices, the starting earnings yield (normalized earnings/price) for U.S. equities has risen to 9%. Stocks have the potential for a growth in earnings, which over the long term has historically been about 1% to 2% above the growth of nominal GDP. Assuming that, over the next five years, inflation runs at 2.5% and the economy grows at its long-term trend of 3%, normalized earnings could easily grow at 6%. The starting yield of 9% plus 6% give stocks an attractive return potential before any valuation repricing. With the earnings yield relatively high, there is room for it to come down and for stocks to be revalued higher.

International Stocks: Neutral

In the third quarter, we reduced our allocation to international stocks slightly due to concerns about currency risk. With prices falling significantly in the fourth quarter and earnings yields rising further, we will be looking for a reentry point to move back to an overweight position. The starting earnings yield is high, the long-term potential for earnings growth is actually higher than the U.S. due to stronger growth overseas, and there is the potential for upward revaluation. Emerging markets are looking particularly attractive at this time.

Real Estate: Neutral*

In our last newsletter, we noted that a cyclical deterioration in the operating environment for commercial real estate sector was beginning to be seen. Vacancies were rising and rent growth was slowing. In addition, the credit crunch has

U.S. and international stocks look quite attractive (continued)

hurt real estate valuations as the cost of capital has risen. As a result, capitalization rates have risen to 6.25%. The deteriorating economy will likely continue to have a negative impact upon operating fundamentals. However, as cap rates move higher and prices come down, there will likely be more interesting buying opportunities. Moreover, the starting yield on real estate makes it a more attractive portfolio diversifier than government bonds or cash that are paying less than 1%. Over the longer term, real estate offers the potential for rent growth and the income stream is not fixed. Historically, rents grow in line with the underlying inflation rate. Any decline in values in the short term should create the opportunity for higher returns in the longer term. Therefore, we are maintaining a neutral position in this asset class.

Alternative Assets: Neutral*

Alternative assets, particularly those geared toward low volatility, have been a nice diversifier to have over the last year. With cash and bond yields extremely low, they have the potential to be even better diversifiers over the next year.

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

Oftentimes, the best opportunities are where capital is fleeing and the worst prospects are where we have been.

TABLE 1

Long-Term (Five Year) Return Prospects

Asset	Starting Yield (1/7/09)	Growth	Potential Valuation
Cash Equivalents	0.05%	0.00%	UP
U.S. 10-year Treasury	2.40%	0.00%	DOWN
BAA Coporate Bond	8.80%	0.00%	UP
U.S. Stocks (E/Y)	9.00%	6.00%	UP
International Stocks (E/Y)	10.50%	7.50%	UP
Real Estate	6.30%	2.50%	DOWN

Sources: Bloomberg, LP, Bailard Research

This table gives Bailard's projections based on assumptions made during our asset allocation review process. It does not represent the past or future performance of any Bailard product, strategy or account. Actual returns will vary.

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U.S. INTEREST RATES	3/31/2008	6/30/2008	9/30/2008	12/31/2008
Cash Equivalents				
90-Day Treasury Bills	1.33%	1.74%	0.92%	0.09%
Federal Funds Target	2.25%	2.00%	2.00%	0.25%
Bank Prime Rate	5.25%	5.00%	5.00%	3.25%
Money Market Funds	2.85%	2.23%	2.25%	2.29%
Bonds				
30-Year U.S. Treasury	4.29%	4.53%	4.31%	2.68%
20-Year AA Municipal	4.79%	4.64%	5.14%	5.21%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 12/31/08	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 Year Treasury Index	12.15%	17.91%	17.91%
Merrill Lynch 7-10 Year Agency Index	10.39%	12.73%	12.73%
Merrill Lynch 5-10 Year Corporate Index	-0.70%	-9.67%	-9.67%
Lehman Bros. Municipal Bond Index	0.74%	-2.48%	-2.48%
International Bonds			
Citigroup non-US$ World Government Bond Index, fully hedged	5.51%	8.01%	8.01%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 12/31/08	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-18.40%	-31.92%	-31.92%
S&P 500	-21.95%	-36.99%	-36.99%
NASDAQ 100	-23.87%	-41.57%	-41.57%
S&P SmallCap 600/Citigroup Value	-24.50%	-29.50%	-29.50%
International Stocks			
MSCI Japan, net dividends	-9.01%	-29.21%	-29.21%
MSCI Europe (includes UK), net dividends	-22.79%	-46.42%	-46.42%
MSCI EAFE (Europe, Australia, Far East), net dividends	-19.95%	-43.38%	-43.38%

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

REAL ESTATE TOTAL RETURNS (US$) THROUGH 12/31/08	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-0.17%	1.82%	1.82%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is lagged by one quarter.

Past performance is no indication of future results.

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About *the 9:05*
Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as the 9:05.

Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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