

SEPTEMBER 2010 QUARTERLY RESEARCH REPORT

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I. Report Overview

» Report Overview

OK. The Recession is Over but Where Do We Stand Now?

On September 20, 2010, the National Bureau of Economic Research (NBER), the official arbiter of economic cycles, announced the 2007 recession ended in June 2009. To make this determination, the NBER looks at a variety of factors such as personal income, payrolls, unemployment, industrial production, and GDP.

More interestingly, it turns out we just experienced the longest recession in the post WWII period, followed only in duration by the 1973 and 1981 recessions. One cannot help but wonder if we have either avoided the inflationary pressures associated with such previously long recessions or if they have only been delayed. Mounting monetary stimulus and the possibility of more down the road most certainly makes this a potential threat.

Although the recession is now over, we somehow doubt “Main Street” America is anywhere near breathing a sigh of relief. Private wages are down nearly \$300 billion since 2007 and even government workers are starting to feel the sting of the recession, losing 159,000 jobs in September. When you account for the number of people that are technically unemployed (a dubious definition) as well as those that have left the labor force, the economy is down about 11.4 million jobs since the recession began.

Let’s also not forget that according to the Mortgage Metrics Report around 3.2 million households are currently in or facing the foreclosure process. So with these sorts of “encouraging” data, one must wonder what sort of an economy we are in store for now that the recession is over.

We’d like to be optimistic about things because we too, as well as our clients, are part of the US economy. However, we must be as realistic and pragmatic as possible in rendering our opinions.

A few big picture items of note relate to the balance sheets of the three major players in our economy, the consumer (~70%), the government (~20%), and private corporations (~10%). Since 2007, the government’s balance sheet is down more than 70% and household and non-profit organizations’ and corporations’ balance sheets are down around 20% as well. As we will demonstrate later in this report, these numbers do not bode well for a strong recovery in GDP growth rates.

Let’s Look at Each Major Component of our Economy Individually

Because of the sheer magnitude of the consumers’ proportion of the economy, they could have a materially positive effect on GDP if spending turns around. However, there are a lot of issues facing consumers. Consumer sentiment levels are near all time lows and this has a direct negative effect on spending. Also personal savings rates are rising and consumers have been paying down debt, which was previously a primary driver of spending.

Household and non-profit net worth is down considerably, and there is a direct relationship between this and spending. And to boot, the Federal Reserve’s strategy to lure people into risky assets with low interest rates is not working, as consumers are increasing purchases of Treasuries at historically low rates, which will only hinder a rebound in household net worth.

There is little explanation needed to demonstrate the government’s capacity to contribute to growth. The 2009 stimulus package has apparently had little effect on the economy and is mostly wearing off in 2010. The political will for a new exorbitant spending package is likely gone regardless of which party wins the November election.

We are seeing debt levels as a percent of GDP rising to historic levels and there is political concern there as well. Taxes as a percent of GDP are slated to rise tremendously and will only hinder economic growth, not to mention the interest rate burden of government debt. Fed Chairman Bernanke continues to espouse willingness for further monetary easing by printing money to keep rates low, but recently this has not necessarily had the desired results on consumer spending and the housing market.

This leaves us with corporations, for which there has been some talk of an export led recovery as the dollar is near historic lows. On the other hand there has also been talk of a globally competitive currency devaluation as many nations seek to export their way out of recession.

So will corporations take the chance of the US winning a currency war and invest to ramp up production, or will they pursue the historic pattern of capital expenditures following net worth lower? Unfortunately, what is more likely is they will use their rebound in profits and cash holdings to engage in M&A activity, a behavior for which there is ample historic precedent.

» Report Overview

How About Some Realistic Expectations

The Congressional Budget Office (CBO) updated their economic forecasts in August and remain, in our opinion, too optimistic. Notable examples include forecasts for 3% to nearly 5% real GDP growth in coming years, CPI averaging just less than 2% over the decade, and 1.8 million jobs created per annum over the next five years. We've often wondered how they come up with these estimates, and it appears they simply ignore prevailing conditions and assume everything will return to trend over time (see page 13). As for their CPI projections, there is little historic precedent to substantiate them.

Our view is that inflation remains a threat, even though CPI has been relatively low the last few years. We cannot ignore the Federal Reserve balance sheet is now more than \$2 trillion and has grown proverbially through printing money. Furthermore, Fed Chairman Bernanke continues to state his willingness to engage in more monetary easing if necessary. The monetary base is up about two and a half fold since 2007 and the velocity of money is at historic lows, which in itself is a serious inflationary threat should it return to normative levels.

Of course the Fed is leading us to believe they will keep inflation under control should it become a problem, but we wonder if they will be able to do so given our society's dependence on debt. We have noticed a disturbing trend between 10 year Treasury rates and societal debt in that they seem to be moving in opposite directions (see page 14). The Fed's ability to raise rates without threatening another recession remains an unresolved question in our opinion.

To sum up our economic outlook, we would start by stating the CBO's forecasts are unrealistic and simply assume a return to trend with little regard for real world conditions. When examining the three major contributors to economic growth, we see no compelling signs any of them will "move the needle" in any sort of strong way, let alone to realize real GDP growth rates ranging between 3%-5% in the next few years.

Instead we tend to believe real GDP growth rates will be subdued for some time and may range around 2% as balance sheets are rebuilt, consumers and corporations de-lever, and the Fed grapples with removing potential inflationary threats from the economy.

Markets are Discounting Risk and A New Low Return Environment Prevails

During the 3rd quarter risk premiums relative to 10 year Treasuries remained essentially unchanged. Given myriad uncertainties facing our economy, we have to say the market is behaving somewhat rationally, but with the exception it does not appear to be discounting the potential threat of higher inflation. Otherwise absolute expected rates of return would be higher.

We cannot help but note we are, in a sense, back to peak 2007 conditions in that we are in another low return environment. Back then, risk premiums were virtually non-existent, and in some instances were negative, with most public markets being priced to return around 5%-7%.

Nowadays we are in a low return environment, but with some of the highest risk premiums in history that are anchored to historically low 10 year Treasury rates. So yet again institutional investors find themselves in a position where virtually any combination of publicly traded investments will be unable to meet their return goals. So this begs the question of "wonderful, so what do we do now?"

Well, the way we see it is you have the same two basic options you had back in the mid-2000s. The first would be to recognize low potential returns and seek to overcome them through portfolio leverage and illiquidity, or more colloquially, high allocations to alternative investments. The problem with this strategy is that low risk premiums tend to revert to high premiums through economic cycles (i.e., losses). When this occurs, leverage amplifies losses and illiquidity precludes the ability to rebalance into higher risk premiums. This is not a good combination.

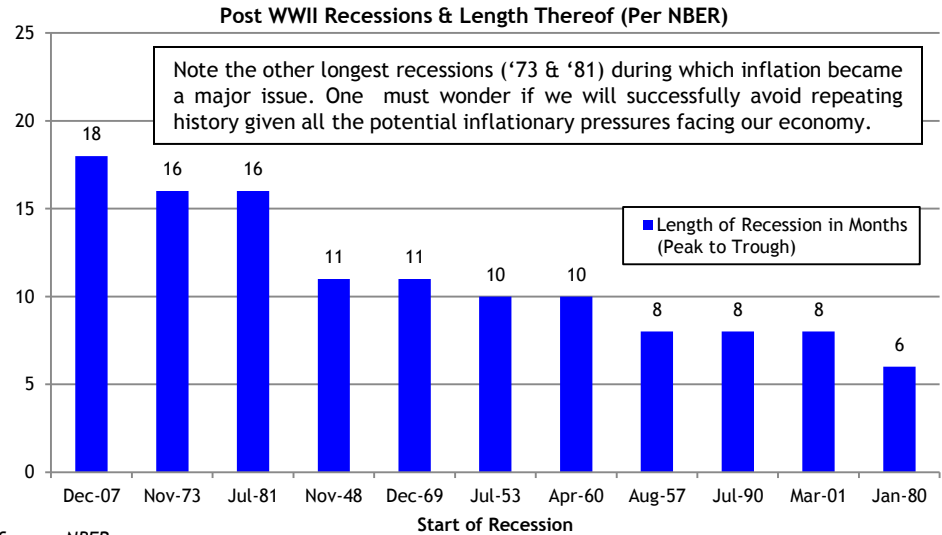
The other far less exciting and palatable option would be a more conservative posture including moderated risk exposures, leverage, and illiquidity in anticipation of rising interest rates resulting from higher inflationary expectations. If this occurs, the CML would shift parallel and upwards, perhaps even flatten some as even low real GDP growth rates should reduce market risk premiums. We would also propose an avoidance of risk free assets that bear the brunt of rising inflationary expectations and instead fixate on higher cash flowing investments to help mitigate the capital markets volatility we're likely to see until economic uncertainties are resolved. Sometimes you just have to accept the market cannot offer the returns you need and simply wait for the opportunities when it does, just like we saw in late 2008 and early 2009.



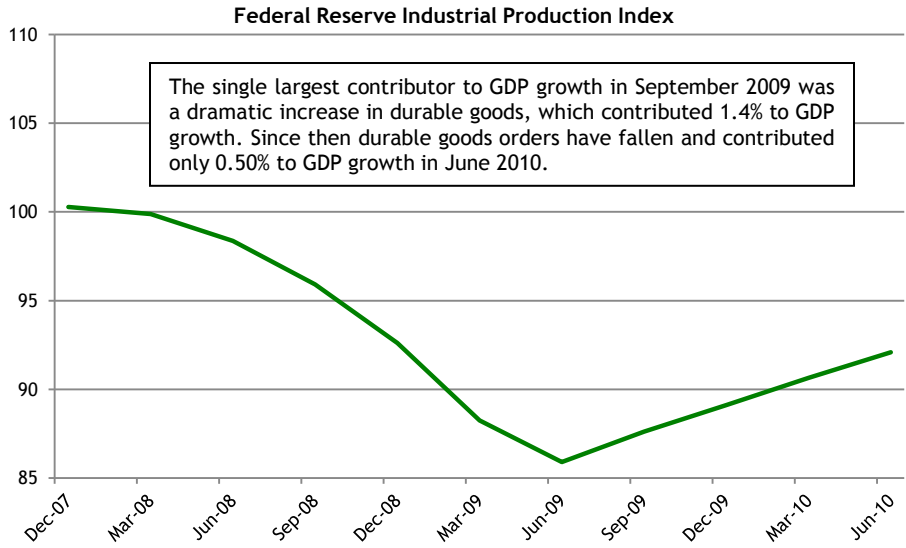
II. Macroeconomics

Officially Speaking, The Recession Ended More Than a Year Ago

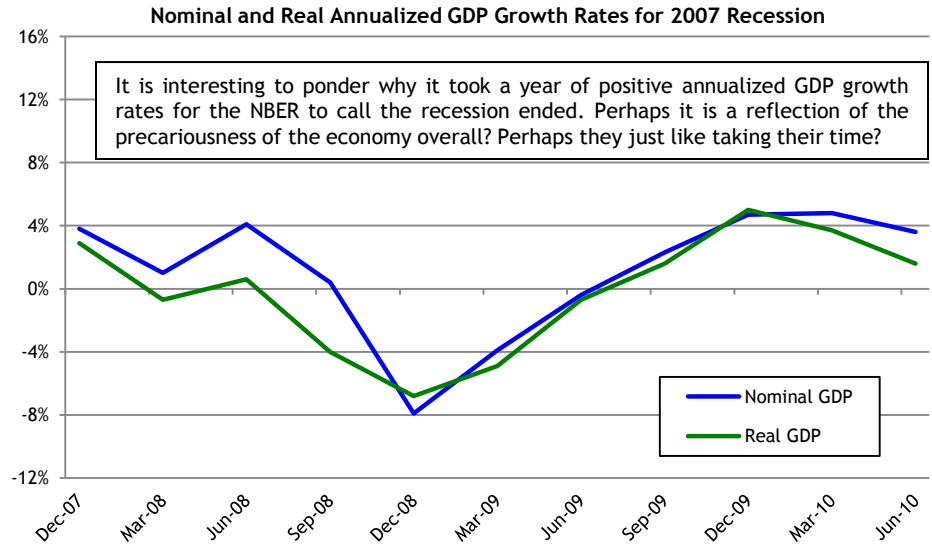
- The National Bureau of Economic Research (NBER) is considered the official arbiter of GDP expansion and contraction. On September 20, 2010, they officially announced the 2007 recession ended in June 2009.
- To reach their conclusions, they look at a variety of factors such as industrial production, personal income, payrolls, employment, and overall GDP growth to name a few.
- As you can see from the charts at the bottom of this page, it does indeed look as if the economy stopped receding in June 2009. You can also see from the top right chart this was the longest recession since WWII.
- Strangely, this does not feel like such great news given where current economic conditions stand. So the real question is where do we stand now and where will we go from here?



Source: NBER



Source: Federal Reserve

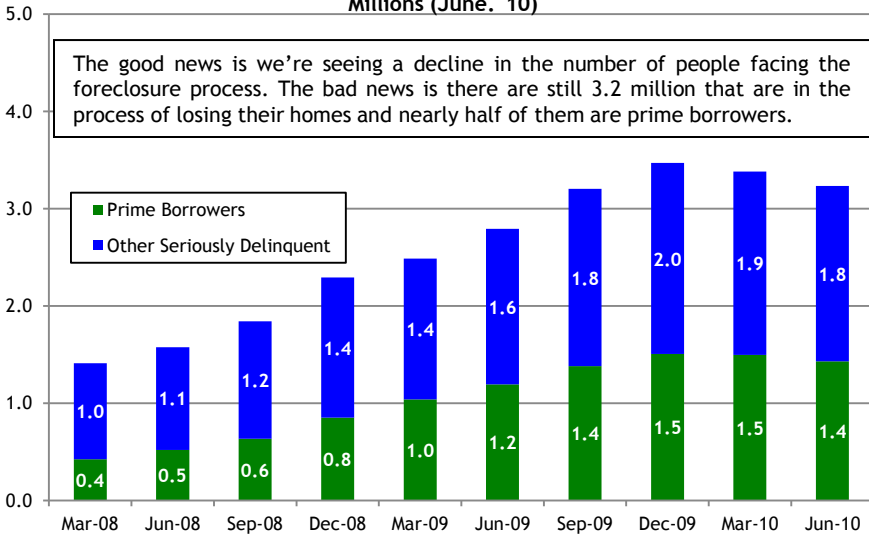


Source: BEA

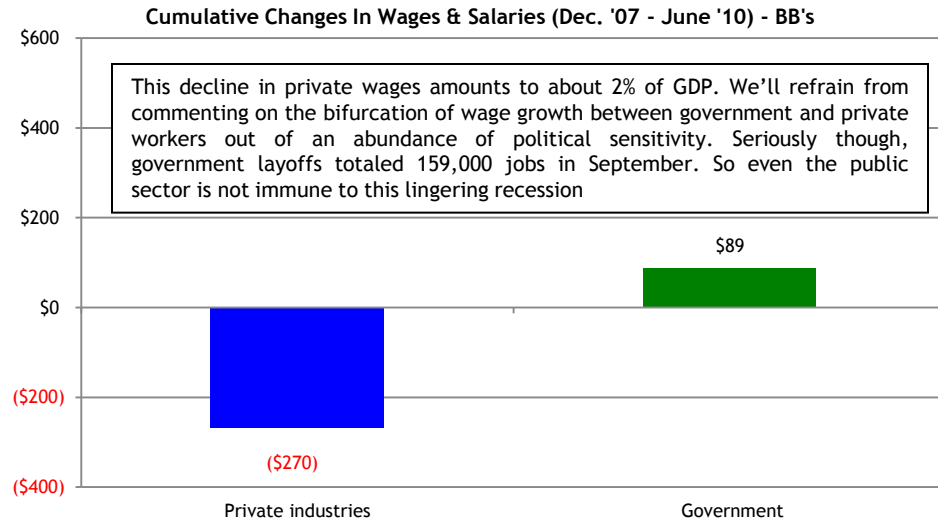
So the Recession is Over, But Where Does “Main Street” Stand?

- Even though the recession is now officially over, we seriously doubt the average American would agree or be happy at this news, especially when the unemployment rate is nearly 10%.
- Looking at some other key macroeconomic factors, we can conclude we remain far from peak 2007 levels.
- For example, private wages and salaries are nearly \$300 billion below peak 2007 levels, which is not helping consumer sentiment and the marginal propensity of people to consume.
- Mortgage markets may be indicating a peaking of foreclosures, but let’s not forget there are more than 3 million households facing the foreclosure process.
- Between those unemployed or having left the labor force, we need to create about 11 million jobs to just get back to where we were a few years ago.

Seriously Delinquent Mortgages & Foreclosures in Process
Millions (June, '10)



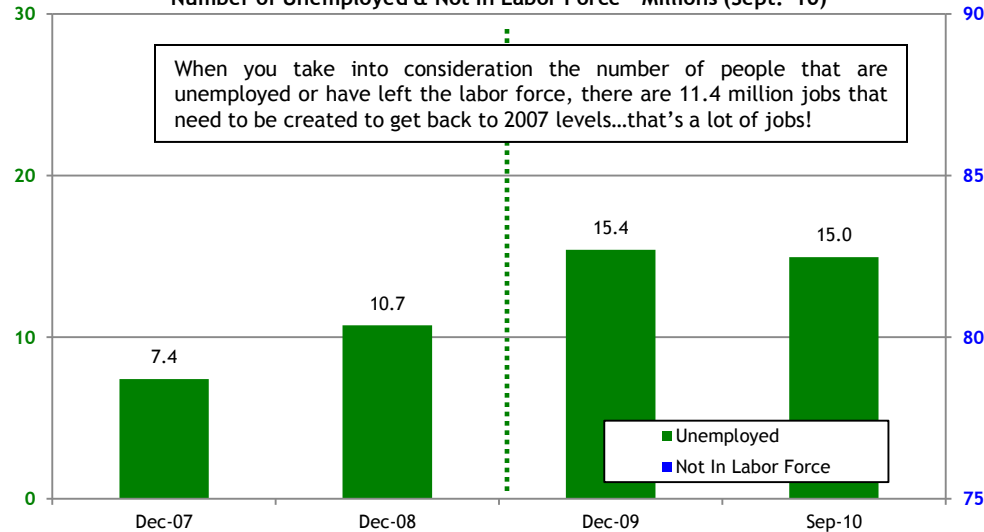
Source: OCC



Source: BEA

This decline in private wages amounts to about 2% of GDP. We'll refrain from commenting on the bifurcation of wage growth between government and private workers out of an abundance of political sensitivity. Seriously though, government layoffs totaled 159,000 jobs in September. So even the public sector is not immune to this lingering recession

Number of Unemployed & Not In Labor Force - Millions (Sept. '10)

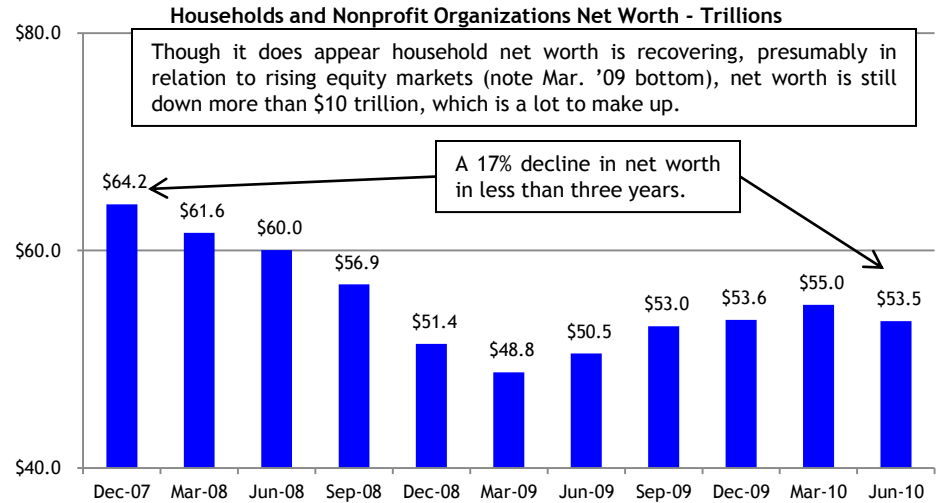


Source: BLS

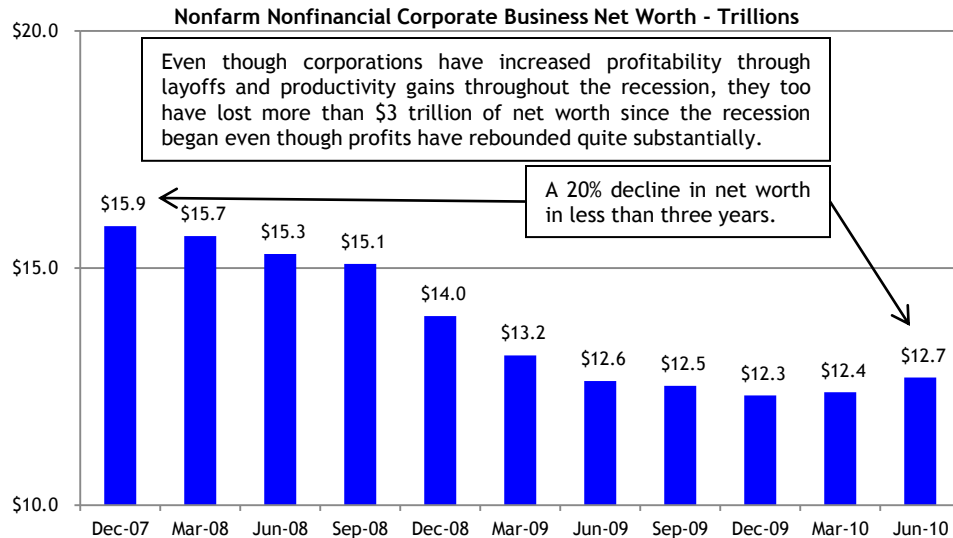
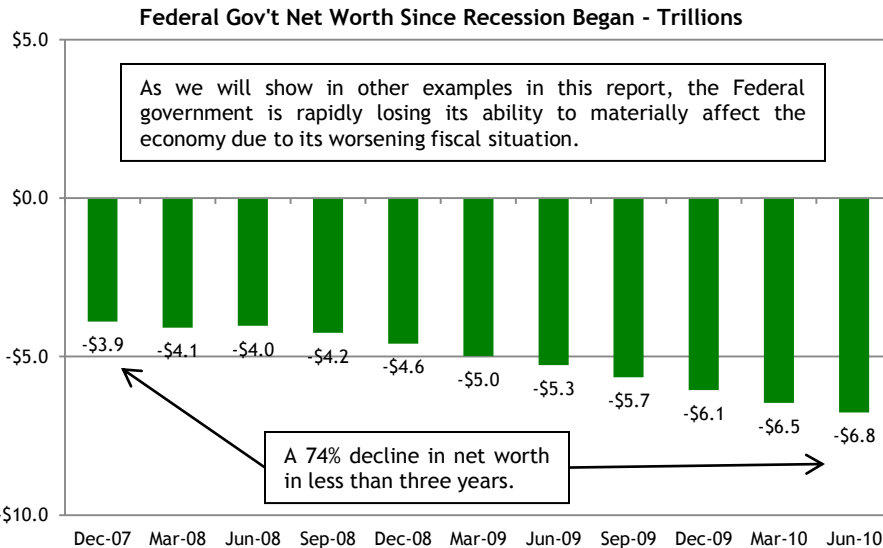
When you take into consideration the number of people that are unemployed or have left the labor force, there are 11.4 million jobs that need to be created to get back to 2007 levels...that's a lot of jobs!

» So Here We Are. What's Going to Drive Future GDP Growth?

- If you've read this far into the report, you may have already asked yourself the question: where do we go from here?
- Well, that's a really good question and the answer is not entirely clear when you take a look at the major forces that can potentially drive economic growth.
- On the following pages we provide far more detailed information on consumers, corporations, and the government, the three primary components of our economy. Let's start however, with a 50,000 foot view of these major economic players and their standing since 2007.
- In all categories we see a consistent trend, which is net worth is down considerably from peak levels, especially for the government. As we will show later, net worth is important when considering potential spending for all parties involved.



Source: Federal Reserve



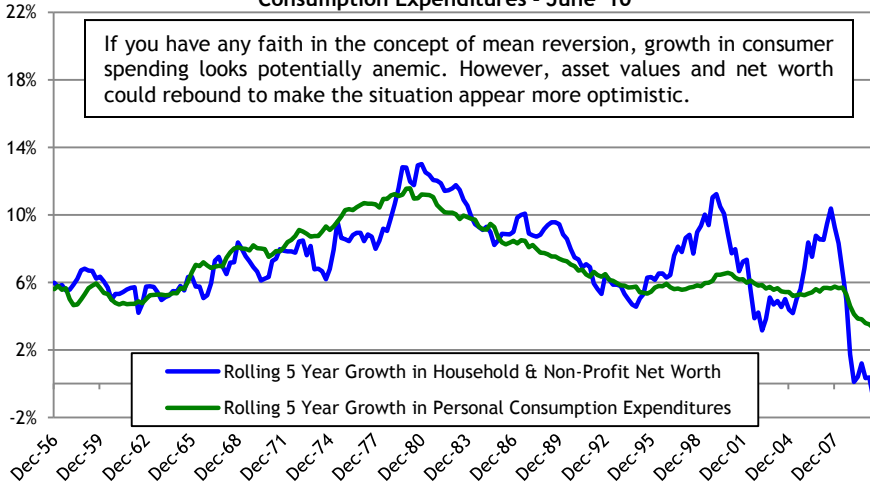
Source: Federal Reserve

Source: Federal Reserve

Will It Be The Consumer That Drives Growth?

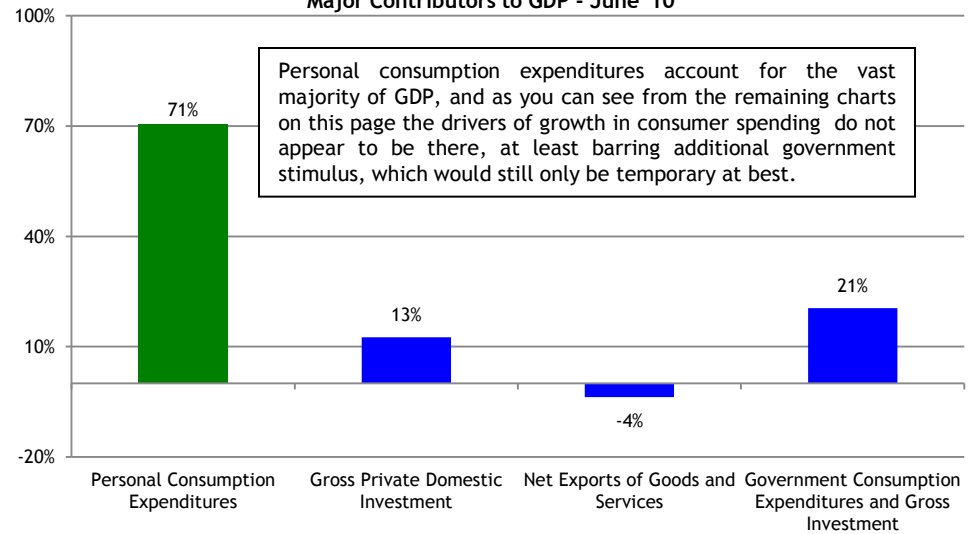
- The US economy is facing a serious problem due to the composition of GDP in that the consumer is well over two-thirds of the economy and the data does not portend a strong consumer spending recovery.
- Over time there is a clear relationship between household and non-profit net worth and growth in personal consumption. By examining this relationship, the only hope for a strong recovery in consumer spending is a rise in net worth, which would require higher investment and home values.
- We must also keep in mind the recent recession had a material effect on consumers' marginal propensity to consume, as evidenced by a higher savings rates and a de-levering of their balances sheets; i.e. paying down debt.
- So we have several factors working against consumer spending, which does not bode well for GDP growth.

The Relationship Between Household & Non-Profit Net Worth & Personal Consumption Expenditures - June '10



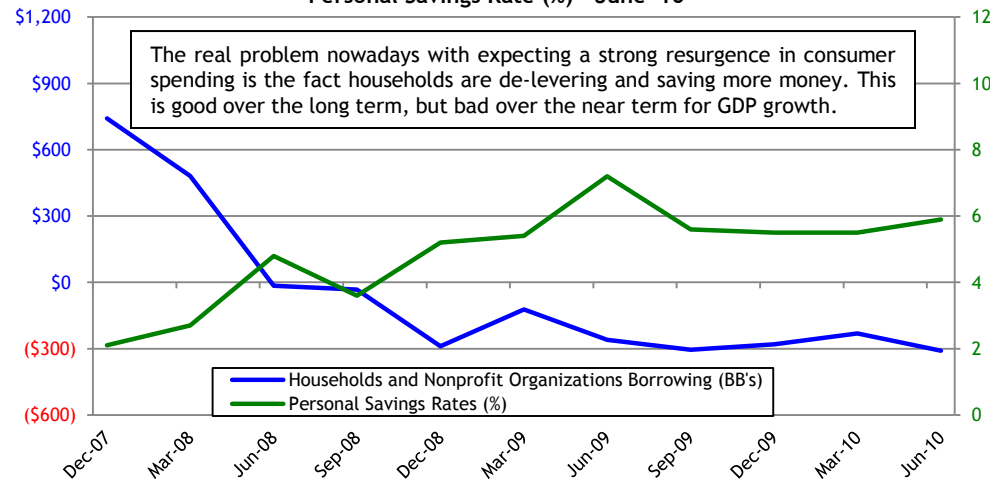
Source: BEA

Major Contributors to GDP - June '10



Source: BEA

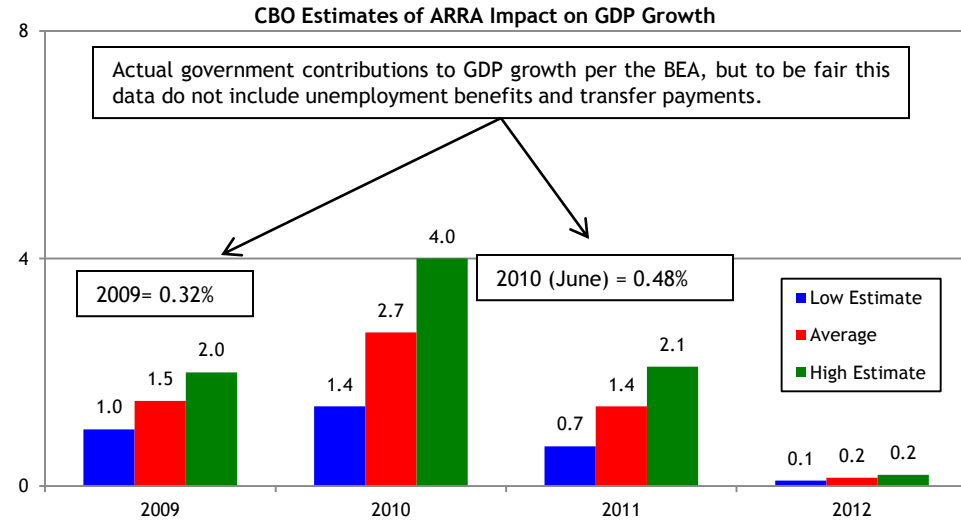
Households and Nonprofit Organizations Borrowing (BB's) & Personal Savings Rate (%) - June '10



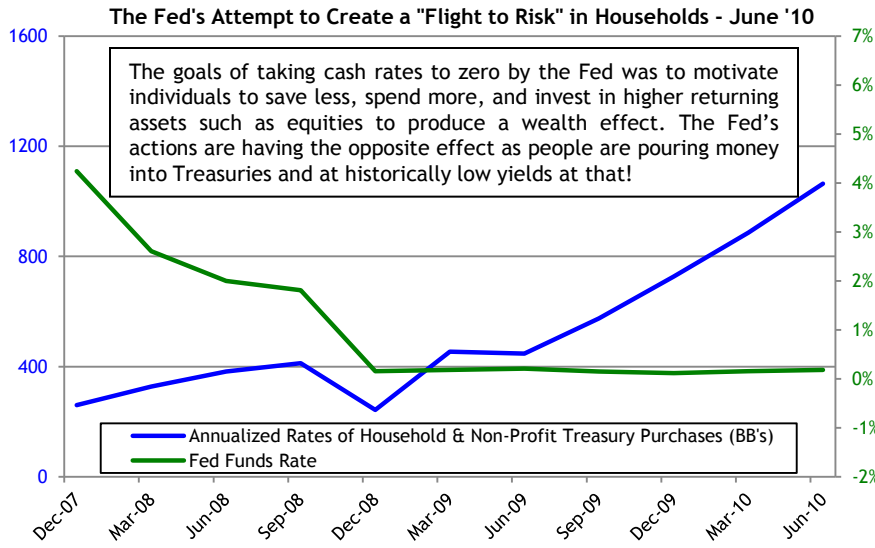
Source: Federal Reserve, BEA

Does the Government Have Any Tricks Left Up Its Sleeve?

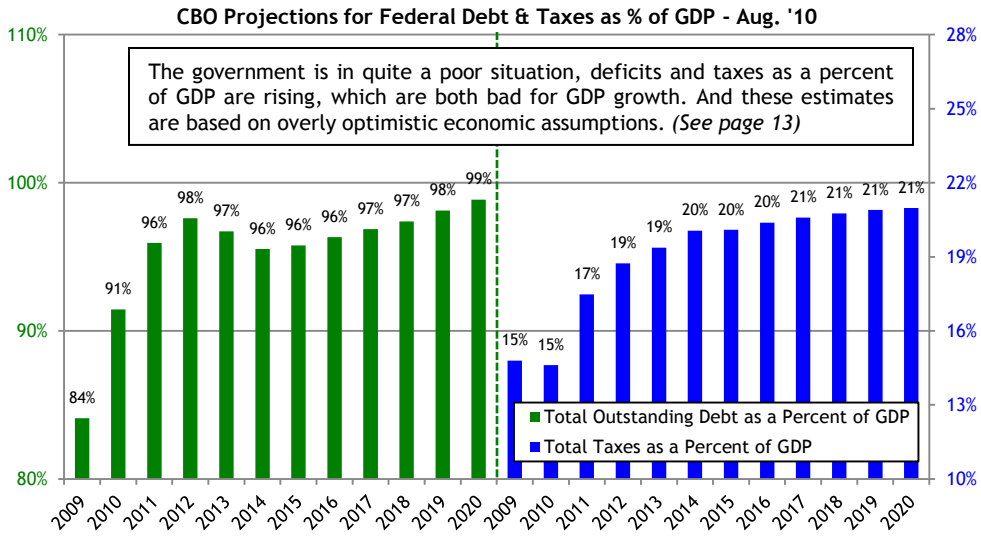
- So if the consumer is not looking like such a strong potential driver of growth, how about the government as the second largest player in GDP? Well, we're sorry to say it looks as if the government may have run out of materially effective options to spur the economy.
- Debt as a percent of GDP is reaching historic levels, and the data shown here do not even account for such things as Social Security and Medicare liabilities. Taxes are slated to rise strongly as a percent of GDP. Both factors are bad for growth.
- We can also see the fiscal stimulus package did not have its intended impact on GDP and Congress will be hard pressed to find the political will to pass another such large measure.
- And finally, the Fed's attempt to drive households into risky assets in the hopes of creating a wealth effect is not working, as people are loading up on Treasuries at low yielding rates.



Source: Congressional Budget Office (CBO)



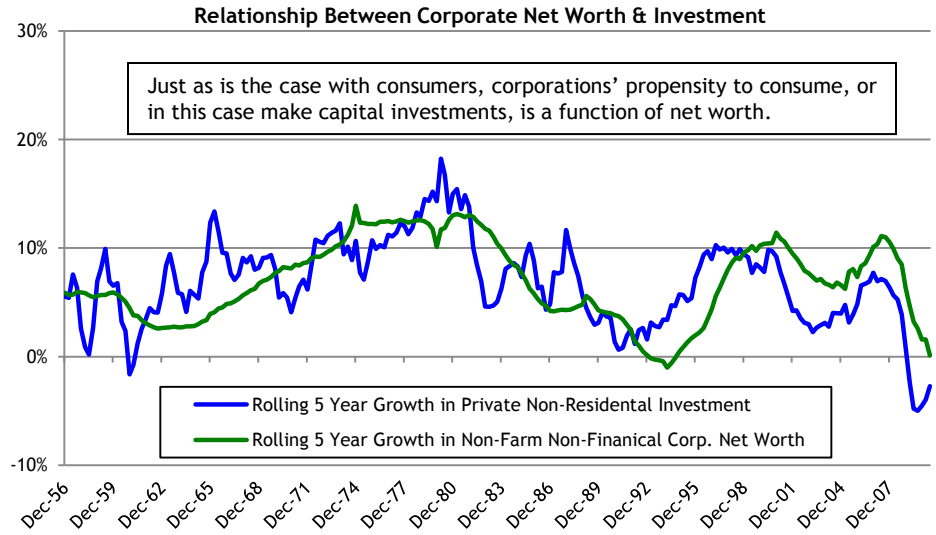
Source: Federal Reserve



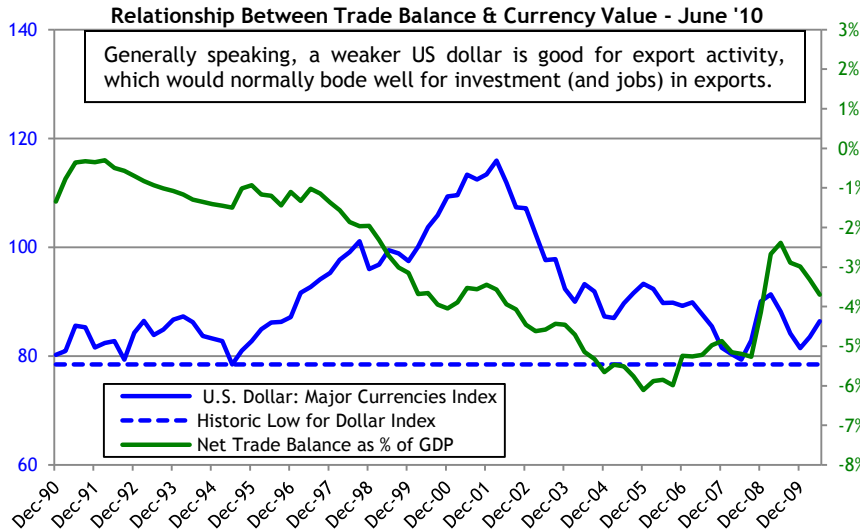
Source: BEA

» How About Corporations as the Drivers of Growth?

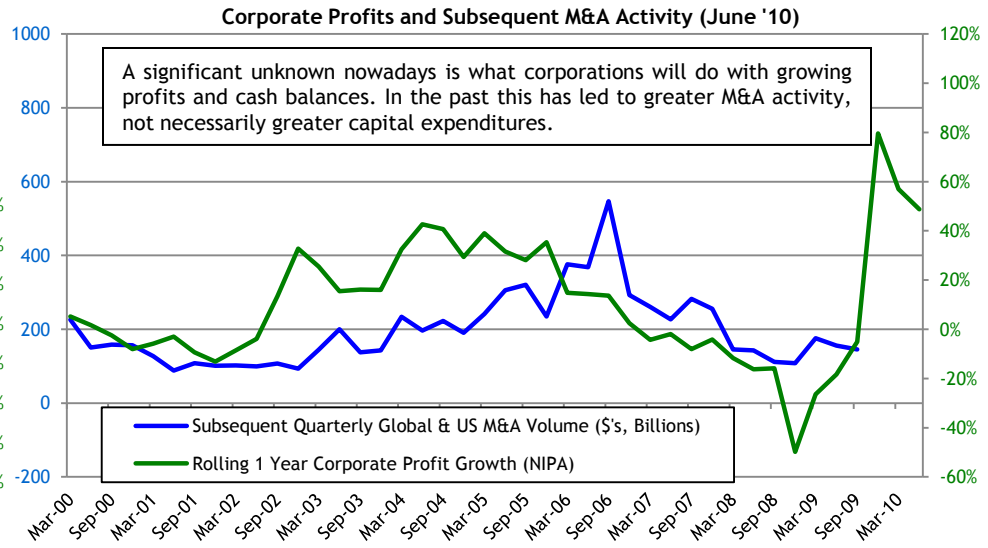
- Private non-residential investment (i.e., corporate investment) is a rather small portion of overall economic activity. So even if there were a strong resurgence in corporate capital expenditures, it would have to be rather big one to make a dent in GDP over the short term.
- Some hypothesize a cheap US dollar may motivate corporations to invest money in ramping up exports, thereby expanding job growth and providing the spark we need for economic expansion. There's a few problems with this theory.
- One, capital expenditures and corporate net worth are linked, and net worth is down considerably. Two, corporations have a tendency to engage in M&A activity with excess cash and profits, especially during periods of low economic growth. Three, rumors of a "currency war," or a global competitive devaluation of currencies are rampant and would work against the concept of an export led recovery.



Source: Federal Reserve, BEA, Wurts



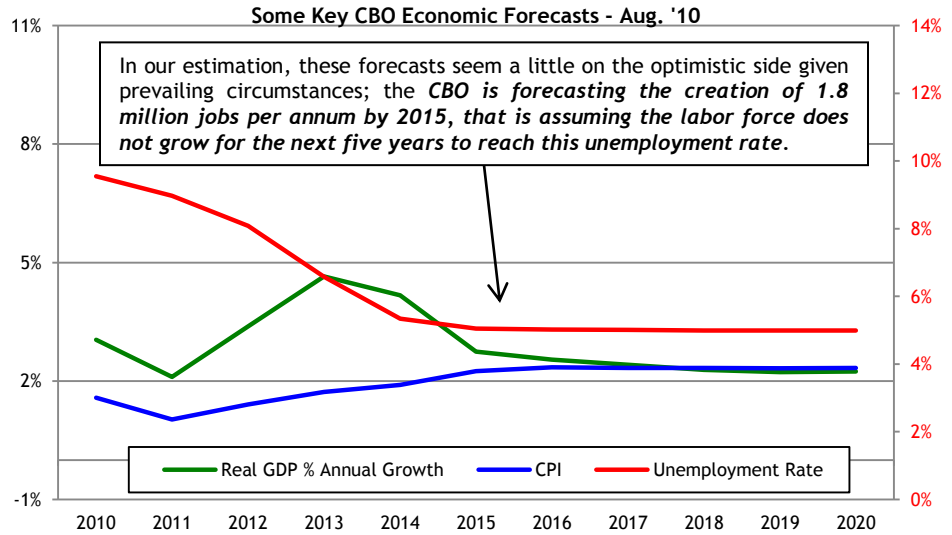
Source: BEA, Freelunch.com, Wurts



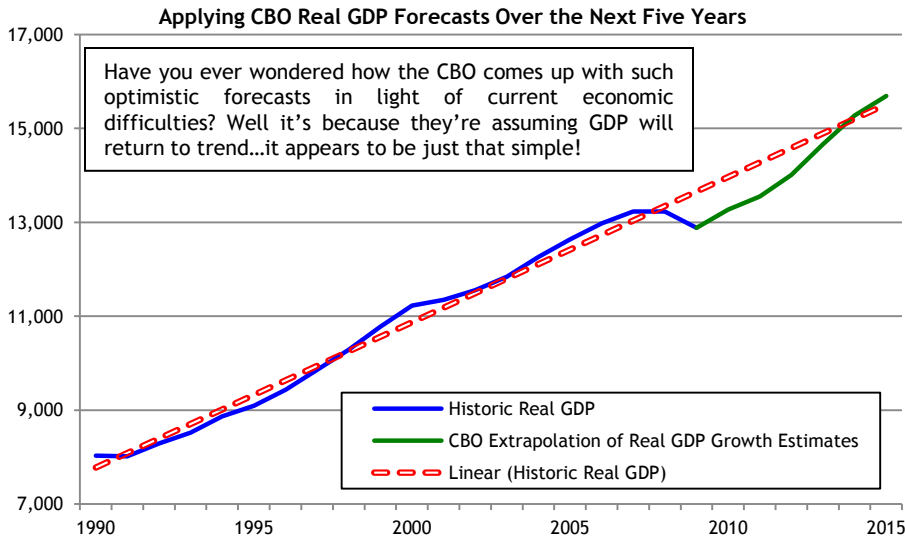
Source: Bloomberg, Wurts

» What Kind of Guidance is the Gov't Providing & Why?

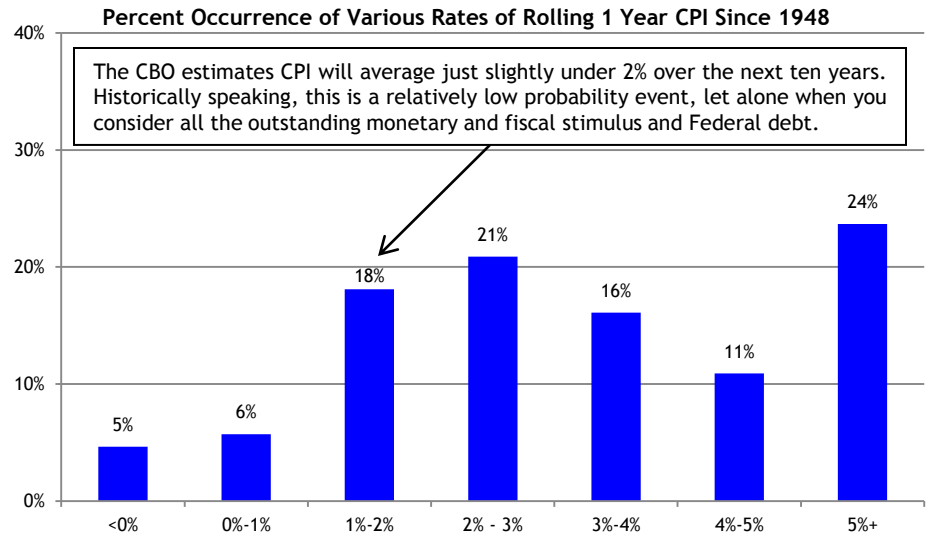
- The Congressional Budget Office (CBO) updated its economic and budgetary forecasts in August, which provides us some insight into the assumptions underlying the aforementioned debt and tax forecasts shown on page 11.
- As said in past reports, the CBO's forecasts tend to be somewhat detached from reality, not with respect to there being historic precedent for their expectations, but because they appear to be non-reflective of prevailing conditions.
- Most notably, their expectations for jobs growth seem utterly enormous over the next five years, not to mention their CPI forecasts are completely unreflective of potential inflationary pressures due to historic fiscal and monetary stimulus.
- We can see some logic in their real GDP forecasts in that they appear to be simply expecting a return to trend growth.



Source: Congressional Budget Office (CBO)



Source: CBO, BEA, Wurts

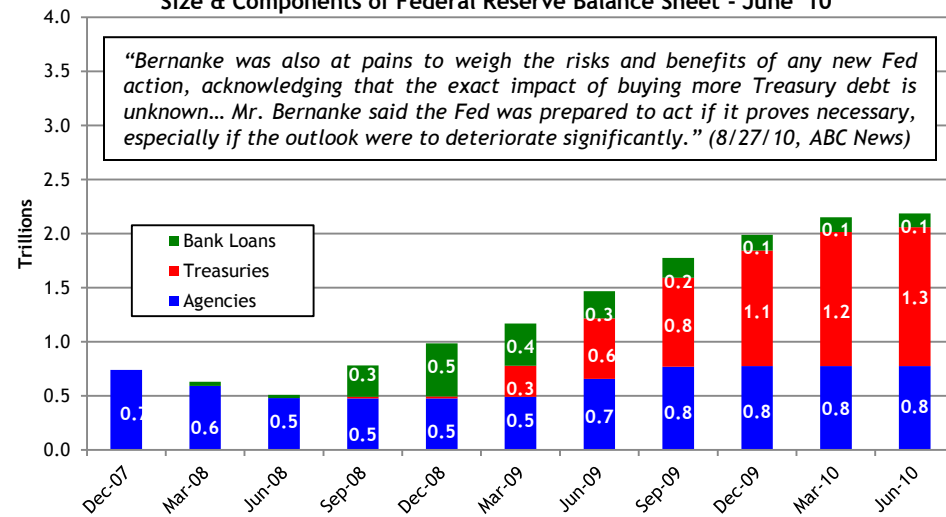


Source: BLS

Should We Still Be Worried About the Threat of Inflation?

- Although inflation has remained subdued recently, this does not mean we should expect it to remain so indefinitely.
- The fact of the matter is the government unleashed unprecedented levels of monetary and fiscal stimulus over the last several years, and has signaled they are willing to add more if necessary to avoid another recession.
- Beyond this, we must also be concerned about a potential resurgence in the velocity of money should consumers change their current de-levering and savings ways. The potential impact on prices could be huge.
- If this were not enough, we have also noticed a disturbing trend over the last decade between 10 year Treasury rates and societal leverage. We quite seriously wonder that even if the Fed wished to head off rising CPI whether it could do so given societal dependence on low rates.

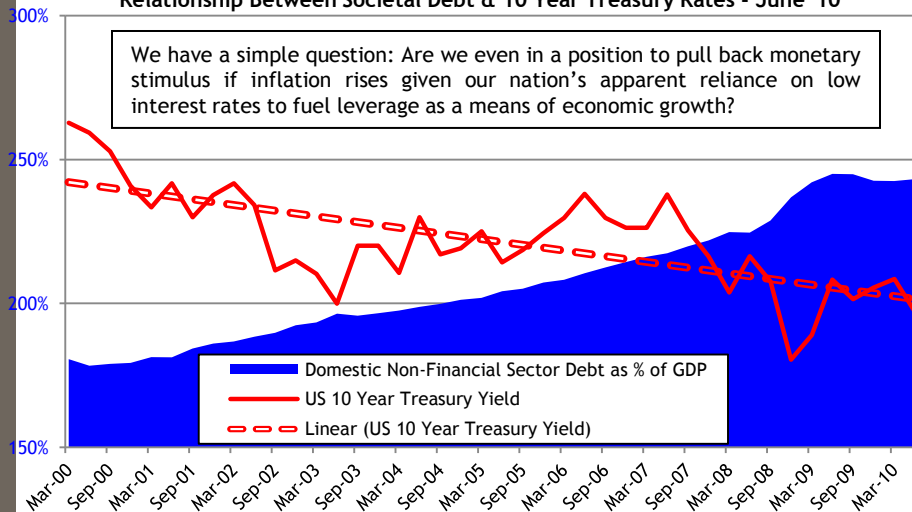
Size & Components of Federal Reserve Balance Sheet - June '10



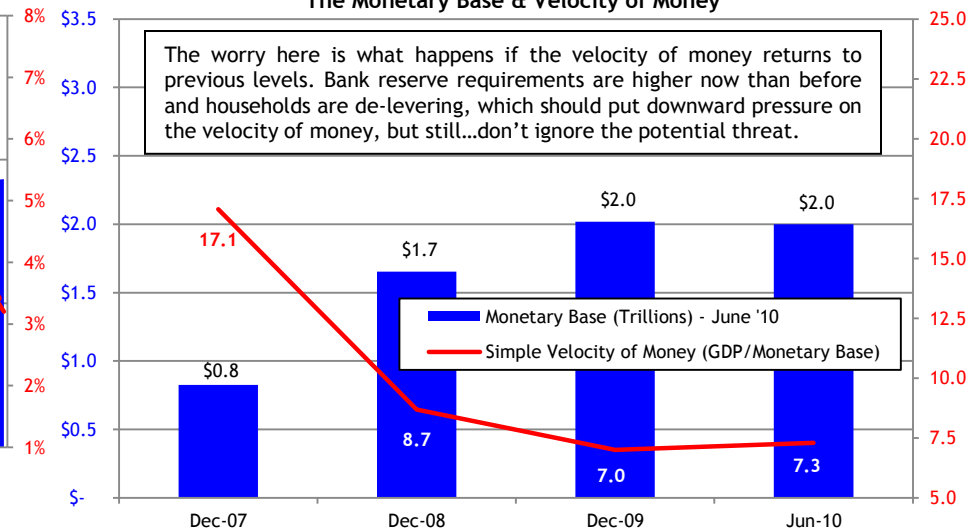
"Bernanke was also at pains to weigh the risks and benefits of any new Fed action, acknowledging that the exact impact of buying more Treasury debt is unknown... Mr. Bernanke said the Fed was prepared to act if it proves necessary, especially if the outlook were to deteriorate significantly." (8/27/10, ABC News)

Source: Federal Reserve

Relationship Between Societal Debt & 10 Year Treasury Rates - June '10



The Monetary Base & Velocity of Money



The worry here is what happens if the velocity of money returns to previous levels. Bank reserve requirements are higher now than before and households are de-levering, which should put downward pressure on the velocity of money, but still...don't ignore the potential threat.

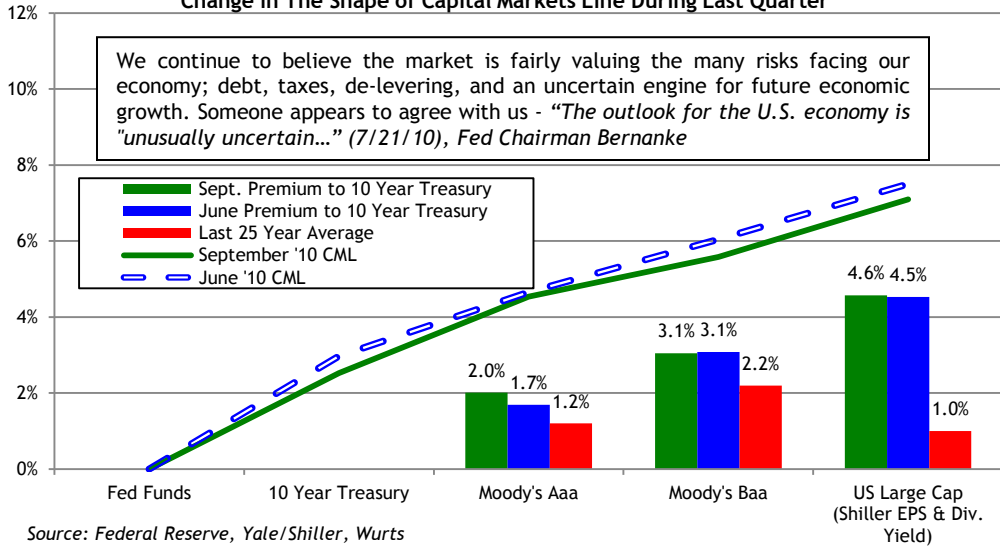
Source: Federal Reserve, BEA, Wurts

Source: Federal Reserve, BEA, Wurts

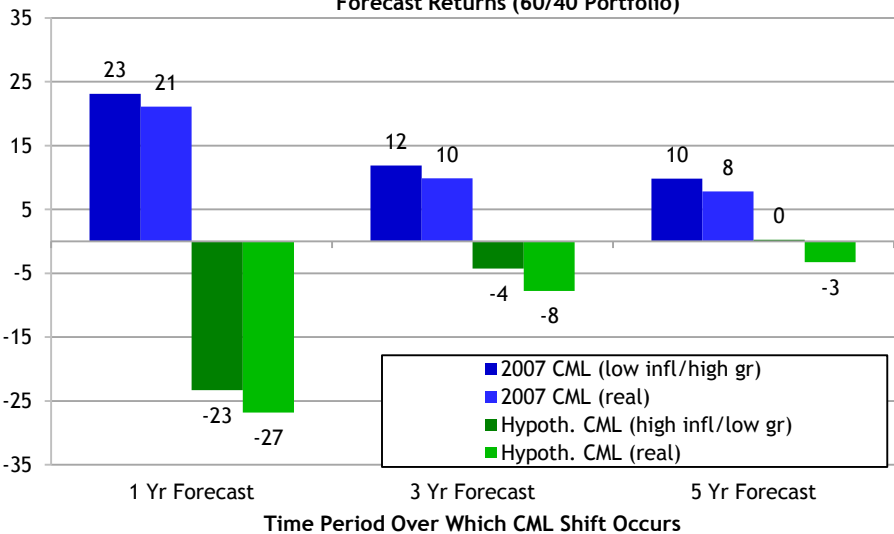
» We're in Another Low Return Environment; a Risky One Too!

- “May you live in interesting times” the old proverb goes. And that is one very good way to describe the current landscape of capital markets.
- For several years prior to the recession, investors everywhere were bemoaning the fact public market returns were too low to meet expected return goals. This was simply because the capital markets line was flat (i.e., 2007) and there were no opportunities to earn meaningful risk premiums.
- Here we are several years later with risk premiums at historic levels, but still unable to create a portfolio of traditional assets to meet most institutions’ return goals because these premiums are anchored to historically low risk free rates.
- We reiterate our concerns of the potential effects of inflation on the capital markets line, in that if it occurs before strong real GDP growth occurs, returns will come under pressure.

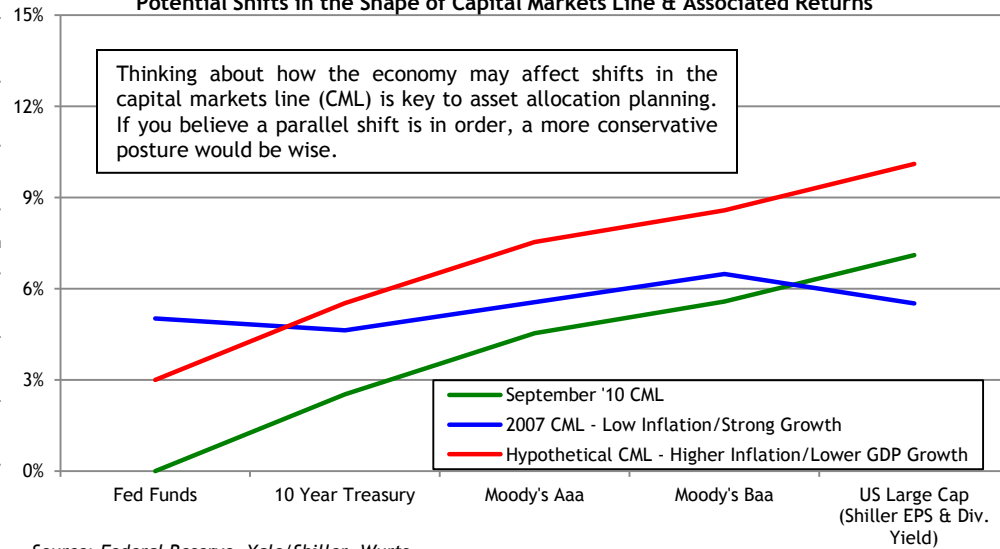
Change in The Shape of Capital Markets Line During Last Quarter



Forecast Returns (60/40 Portfolio)



Potential Shifts in the Shape of Capital Markets Line & Associated Returns



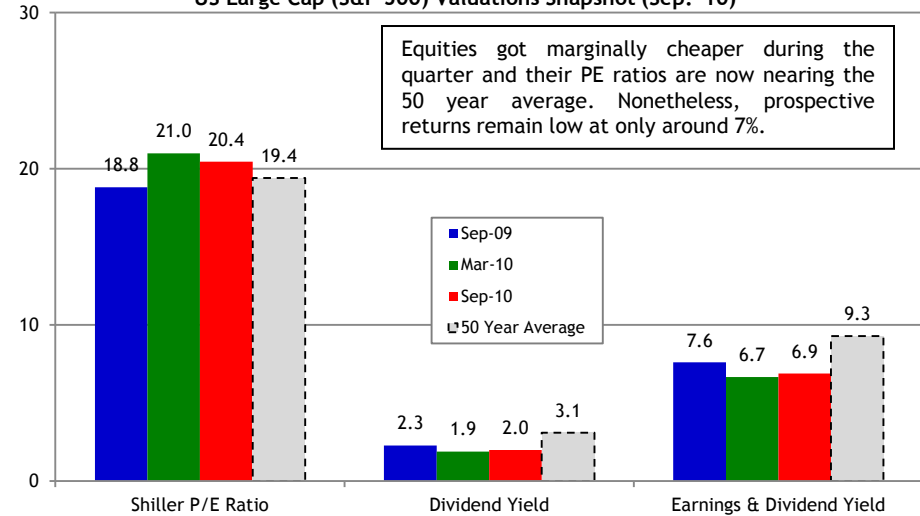


III. Capital Markets

» A Little Choppiness in Large Cap US Equities

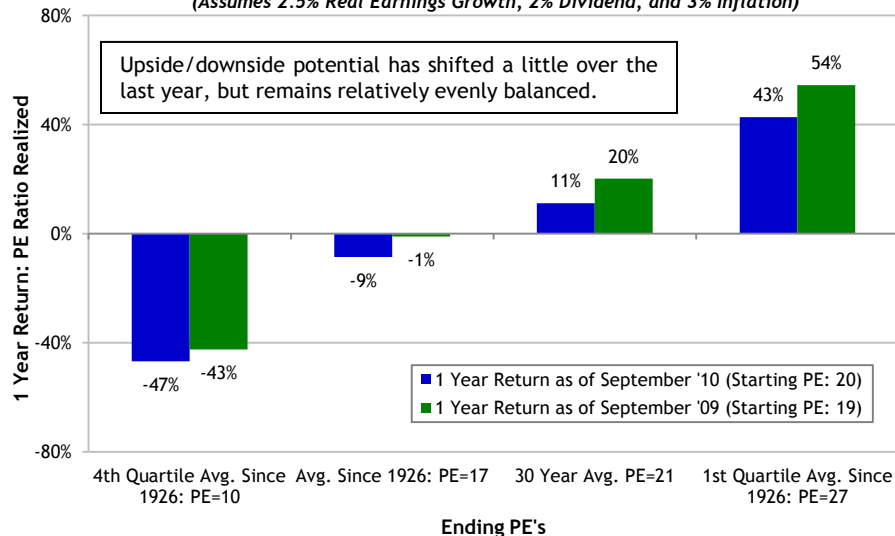
- As we have been saying for the last several quarters, there is not a lot of reason to expect strong valuation upside in US large cap stocks given all the difficulties facing our economy.
- During the last year PE ratios seem to have found and oscillated within a relatively narrow range around historic values over the last fifty years.
- There is a little less upside in equities than a year ago as valuations have shifted slightly higher.
- Our overarching concern with equities in this environment remains in that theoretically implied expected returns are just too low to meet most institutions' return goals. Moreover, we worry about the potential effect of inflation on valuations and the losses it could produce if it rises before we see strong real GDP growth; i.e., risk premiums remain and valuations fall.

US Large Cap (S&P 500) Valuations Snapshot (Sep. '10)



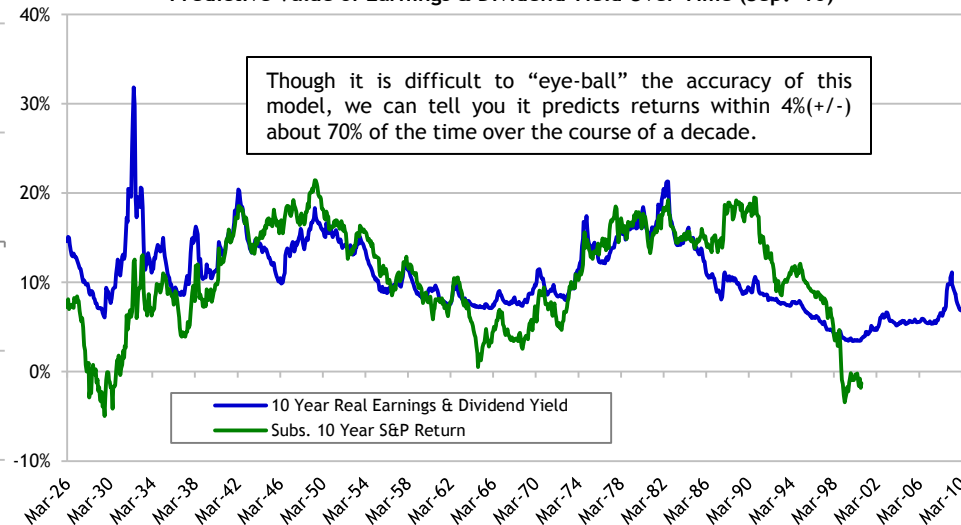
Source: Shiller, Wurts & Associates

Effects of Changes in Shiller PE Ratio on S&P 500 Returns
(Assumes 2.5% Real Earnings Growth, 2% Dividend, and 3% Inflation)



Source: Shiller, Wurts

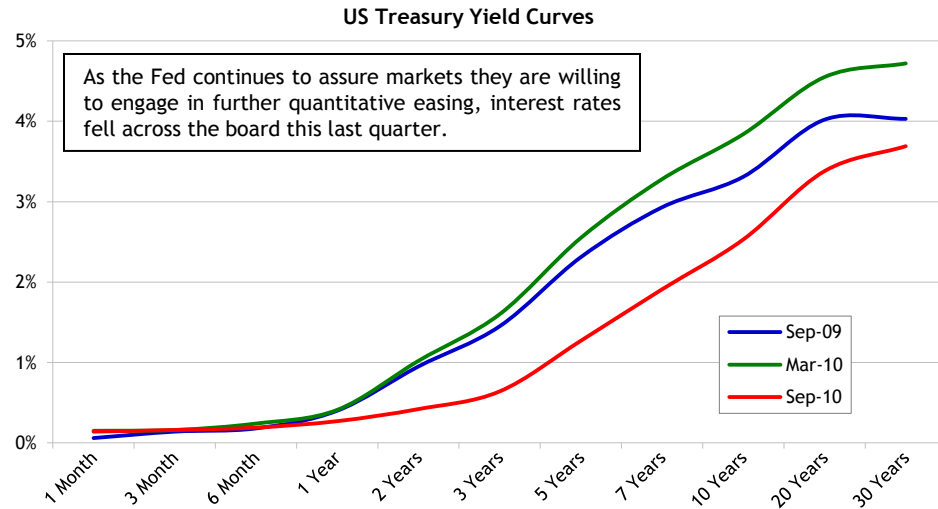
Predictive Value of Earnings & Dividend Yield Over Time (Sep. '10)



Source: Ibbotson, Shiller, Wurts

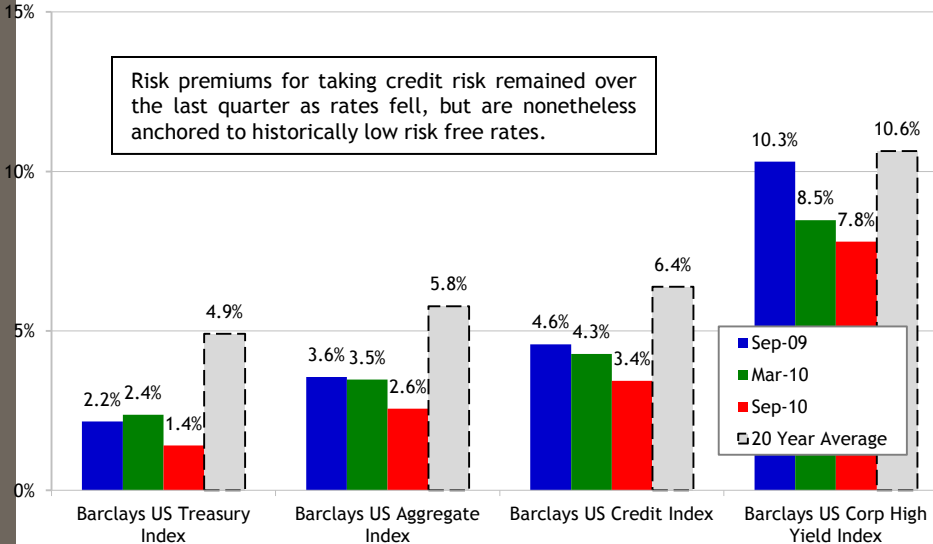
» Treasuries Seem Once Again at Bubble-ish Levels

- The Federal Reserve has made many comments in the last quarter to assure market participants it will conduct further monetary easing to preclude either deflation or a double-dip recession through the purchase of Treasury bonds.
- These comments are creating several problems for institutional investors.
- They are pushing yields to historic lows making it difficult to achieve return goals, while at the same time setting up potential losses as rates inevitably rise due to either strong GDP growth or a resurgence in inflationary expectations; i.e., the shifting in the capital markets line.
- Credit exposure will provide some protection against rising rates, TIPS seem relatively attractive for a risk free asset, but Treasuries once again seem priced at bubble-ish levels.



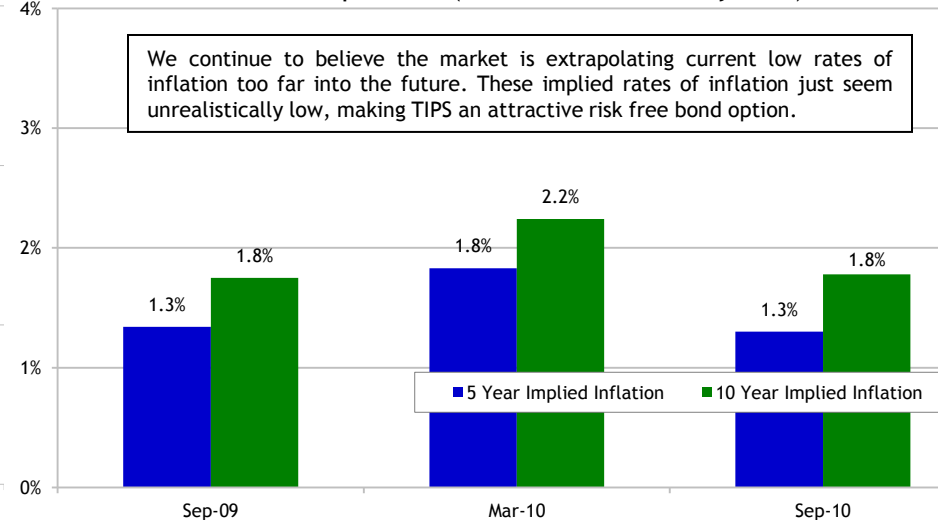
Source: Federal Reserve

Nominal Fixed Income Yield to Maturities



Source: Barclays

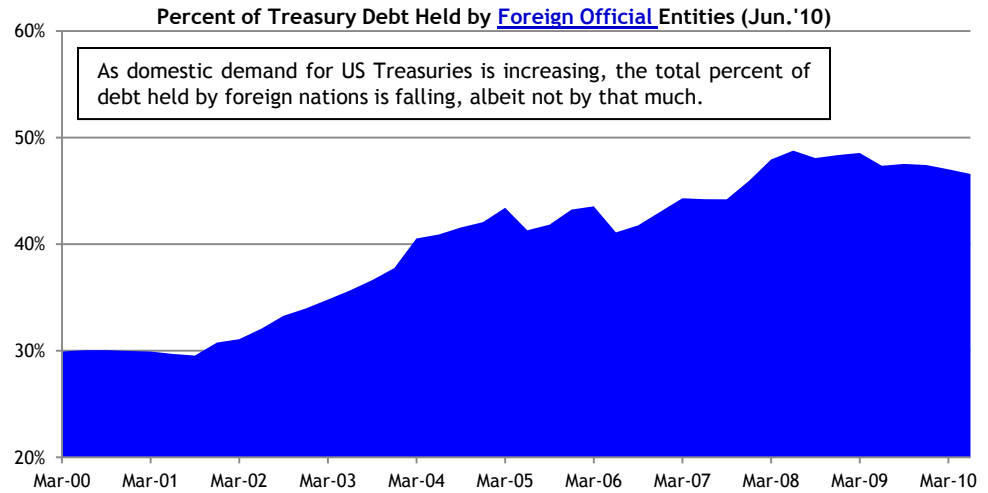
Inflation Expectations (Nominal less Real Treasury Yields)



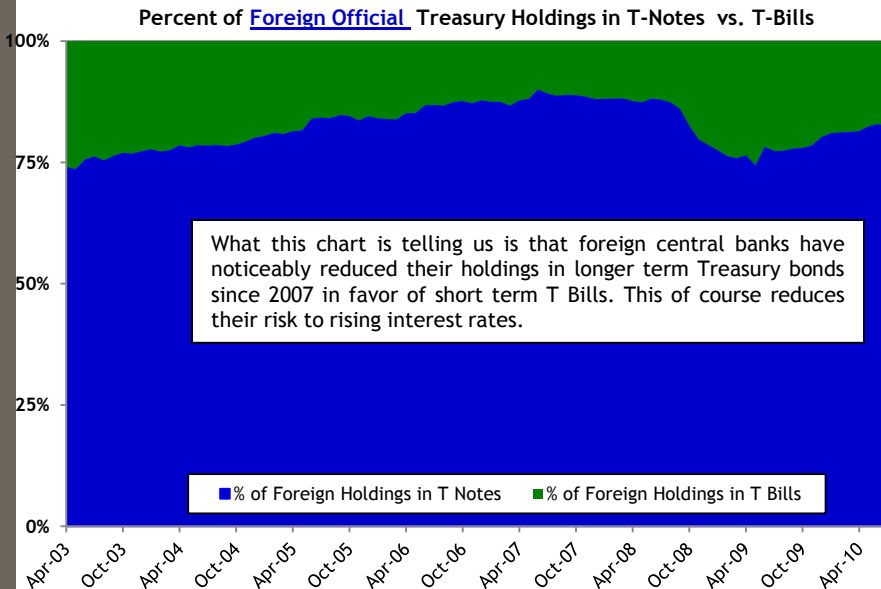
Source: Federal Reserve, Wurts & Associates

» Domestic Treasury Demand is Rising and That's Not so Good

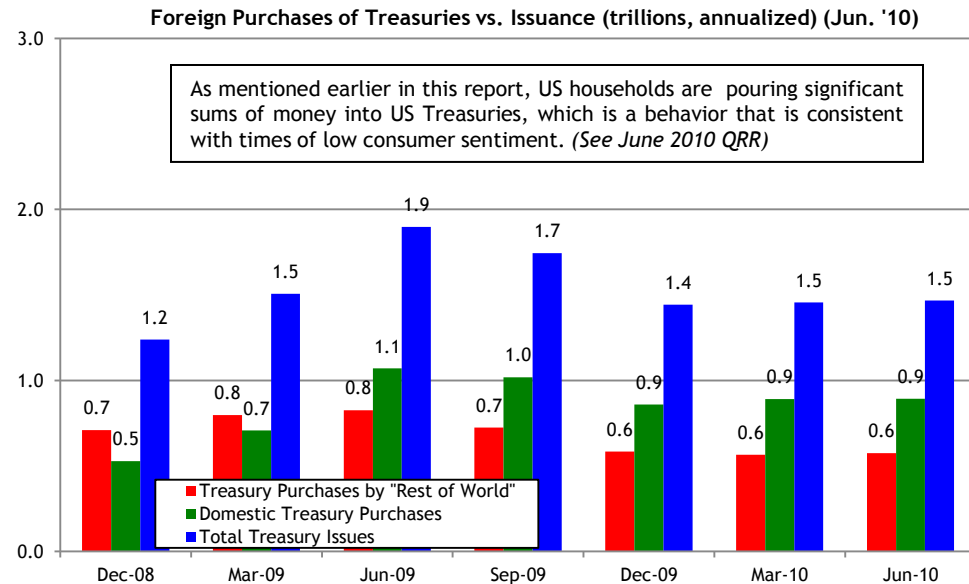
- Over the last decade it was commonplace to hear people complain about how much of our debt was being purchased by foreign investors and our reliance upon them to finance Federal deficits.
- Well, these foreign investors were purchasing our debt at substantially higher interest rates than we've seen in the last several years and are now shifting more toward short term debt, presumably out of fears of rising rates.
- Domestic purchasers are now outpacing foreigners, and this is not such a good thing because they are doing so at historically low rates in an environment where these returns are likely going to be eaten up by inflation or rising rates. This is bad for future household net worth and therefore consumer spending over time.



Source: US Treasury, Federal Reserve, Wurts & Associates



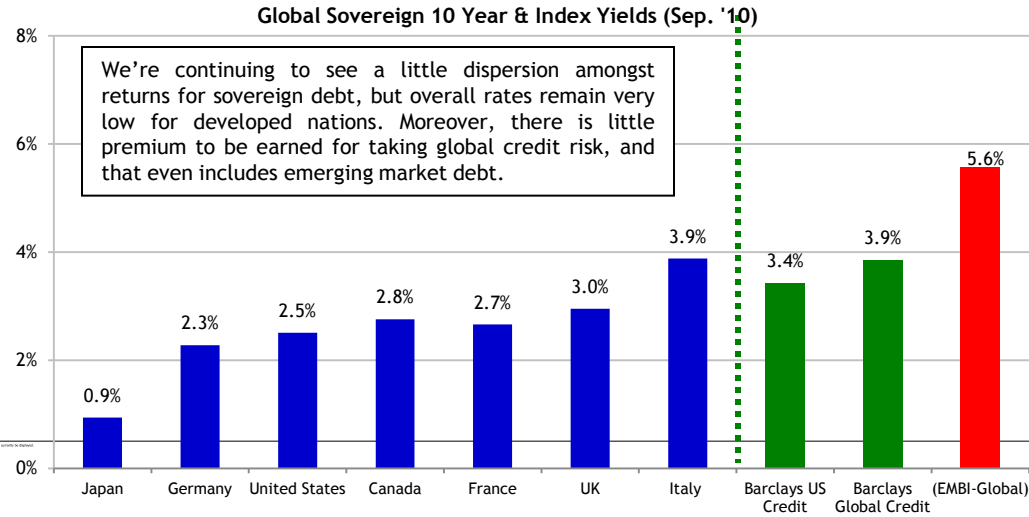
Source: US Treasury, Ibbotson, Wurts & Associates



Source: Federal Reserve

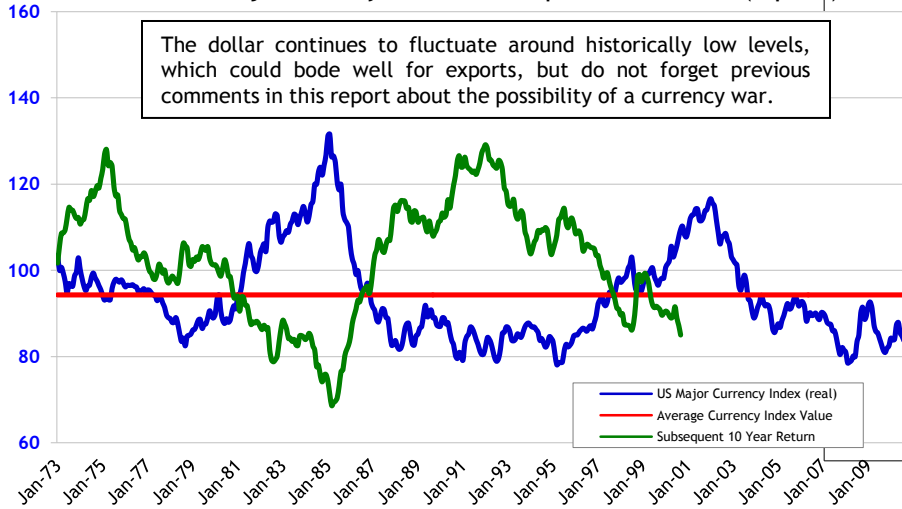
» There Doesn't Appear to Be Any Fat Pitches in Global Markets

- There is a concerted global attempt to bring the world's economy back to strong GDP growth through lowering interest rates and accommodative monetary policy.
- The side effect of these actions is global investment markets appear to be converging upon one another, offering up little rationale for identifying compelling investment opportunities.
- We also see the same concerns globally as we do domestically in what may happen to interest rates when strong GDP growth returns.
- Let's also not forget about the threat of global inflationary pressures as nations may be in the beginnings of competitive currency devaluing to export their way out of slow economic growth.

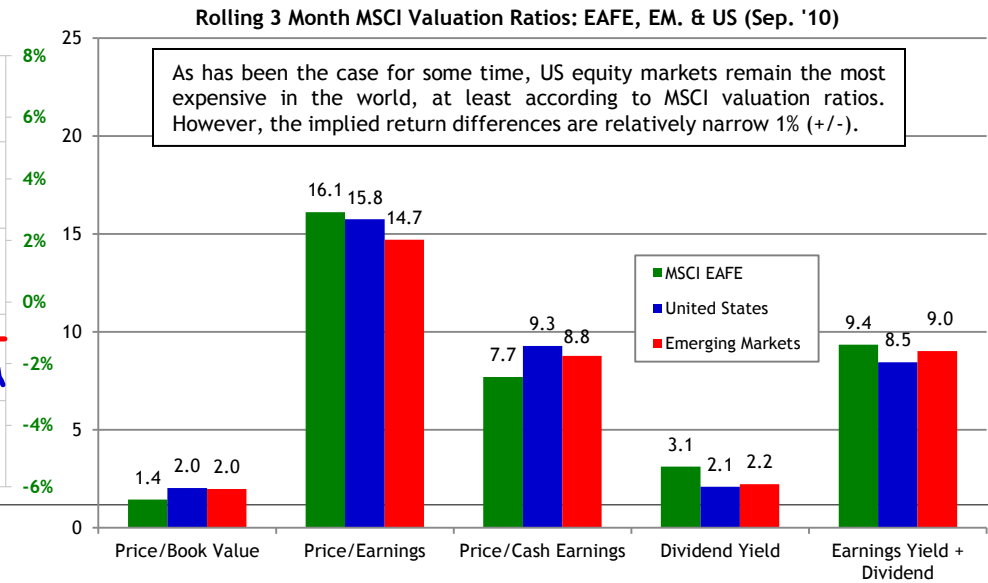


Source: JPMorgan, Western Asset Management

US Dollar Major Currency Index vs. Subsequent Performance (Sep. '10)



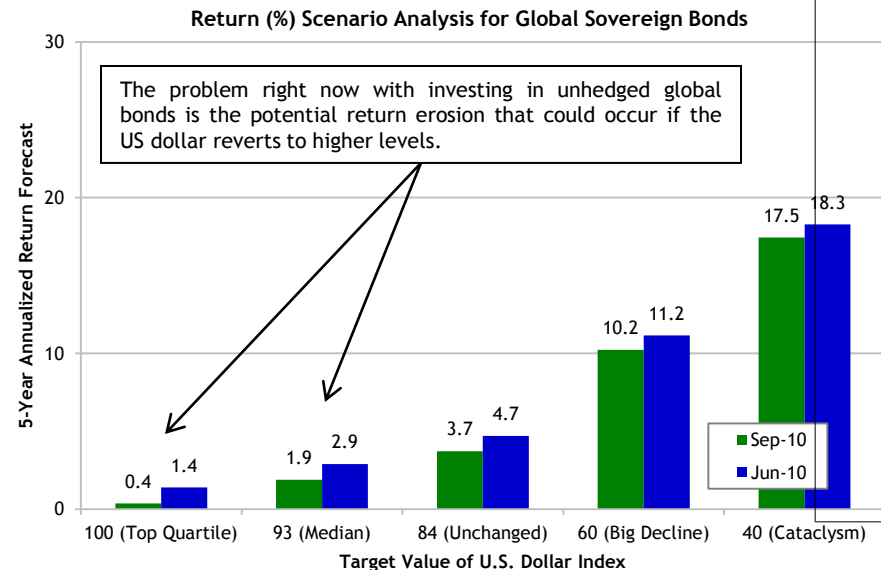
Source: Freelunch.com; Wurts & Associates



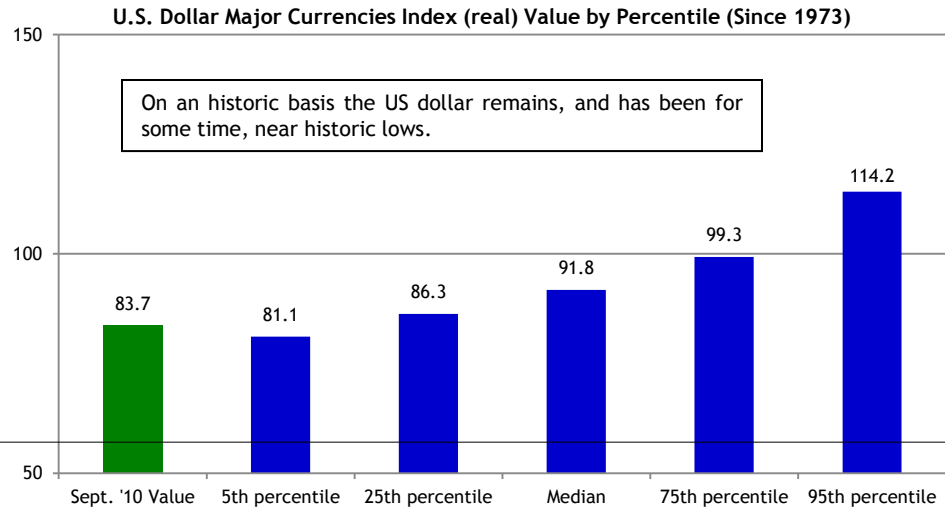
Source: MSCI; Wurts & Associates

» Betting Against the Dollar is Becoming More Complicated

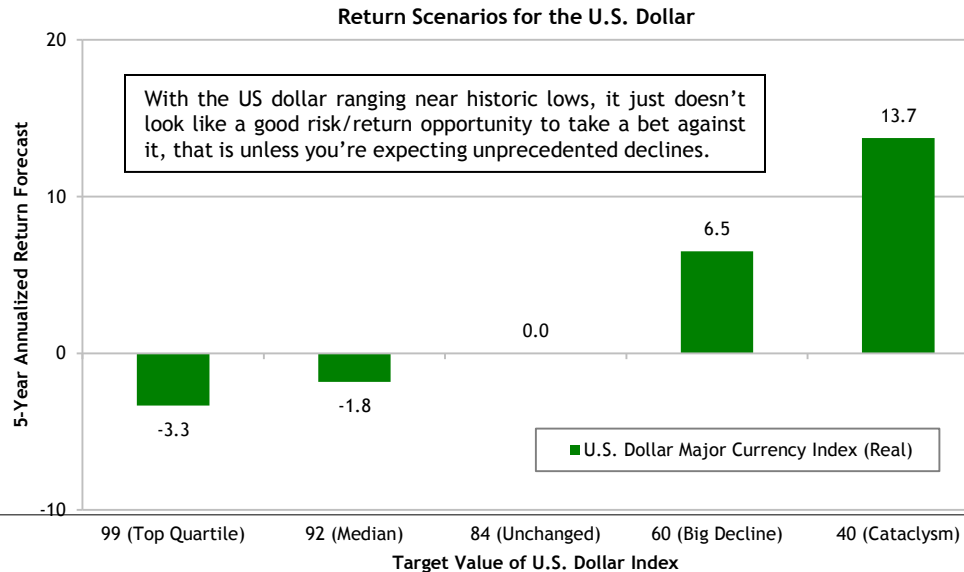
- The problem with betting against the US dollar, most often done through unhedged global bond positions, is getting complicated and unclear for a variety of reasons.
- To begin with, the US dollar is near historic lows and something significant would need to happen for it to fall materially further and make such a bet worthwhile.
- If we were to see higher rates of inflation this could happen, but those rates would have to exceed other global currencies. Given recent talk of competitive global currency devaluation, a bet against the dollar may not be such a good idea.
- On the other hand, the US may somehow orchestrate a return to strong GDP growth while keeping inflation tame, which would work against such a bet; seems unlikely to us though.



Source: Wurts



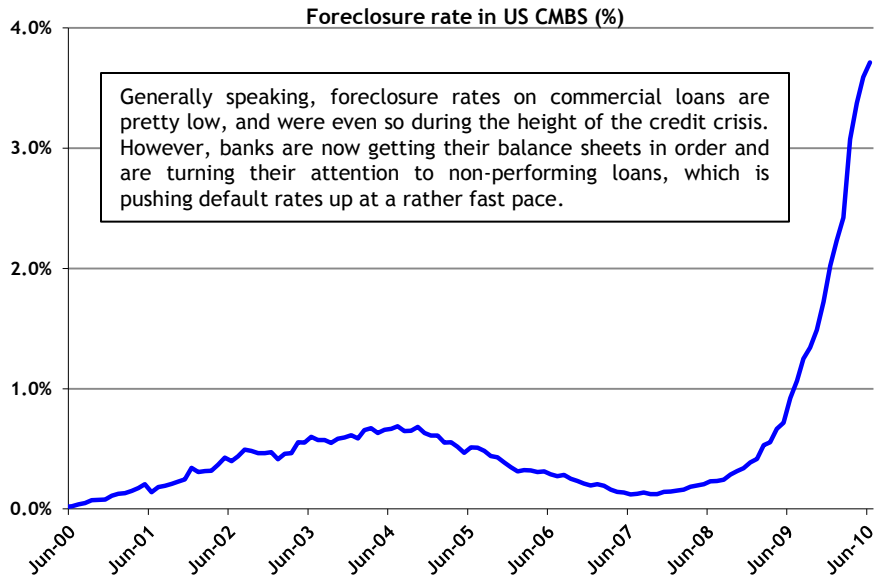
Source: Freelunch.com, Wurts



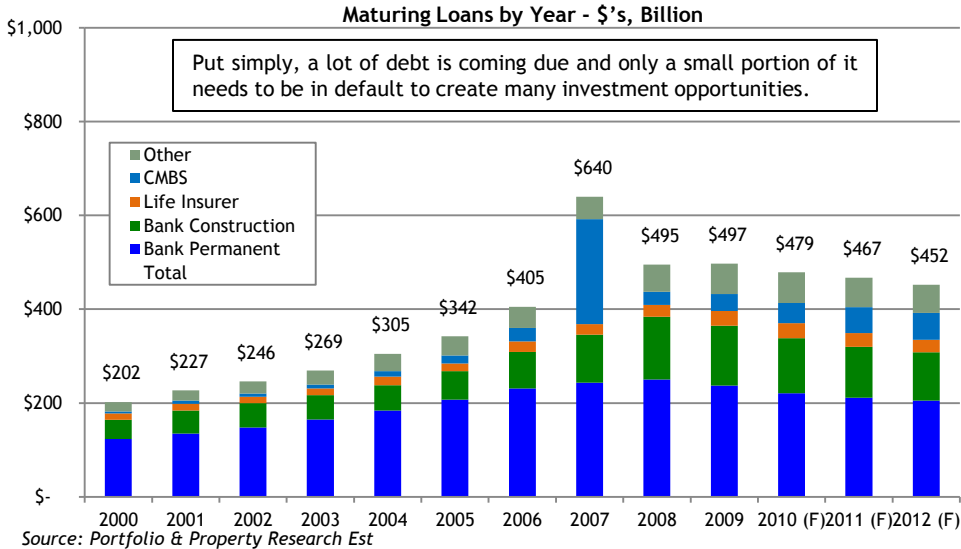
Source: Wurts

Real Estate Debt Related Opportunities Likely to Abound

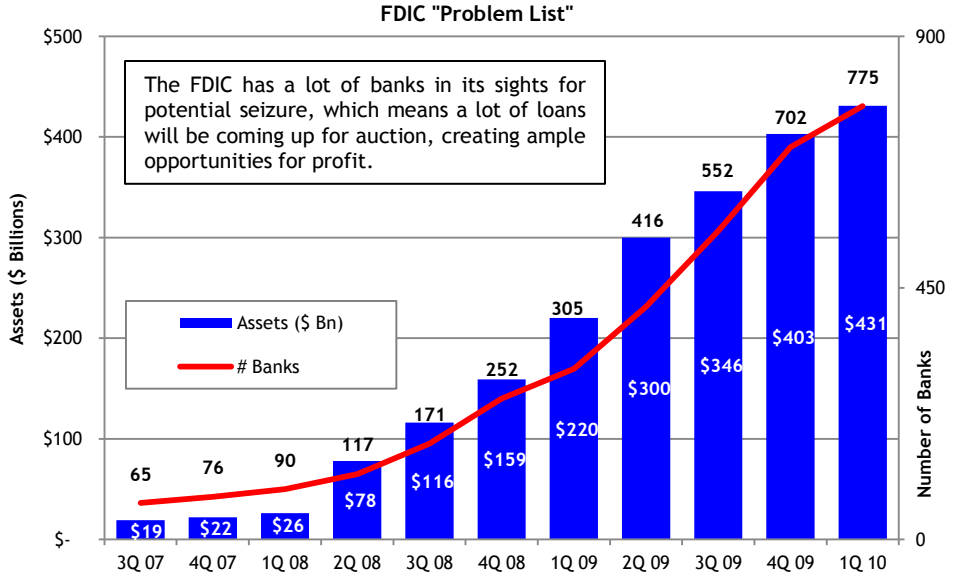
- During the height of the real estate bubble in 2007, due to excessive investor demand, too much leverage was taken out on property values that were unsustainable.
- Hundreds of billions of dollars of real estate debt will be coming due in upcoming years that will need to be refinanced. Of course not all of these loans will go into default or fail to be refinanced, but many will, which will create opportunities.
- We expect a bifurcation within this opportunity set as larger investors should be able to refinance, versus smaller property holders that will not likely be able to refinance their holdings.
- We must also keep in mind the FDIC is actively ramping up their seizures of banks with too many of these assets on their balance sheets, with the goal of auctioning off these loans literally at fractions of their original values.



Source: TREPP, J.P. Morgan



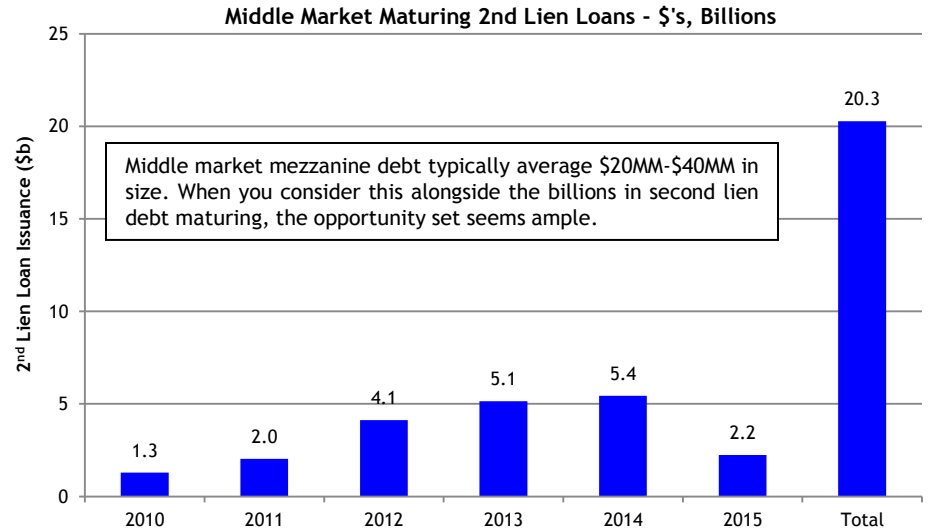
Source: Portfolio & Property Research Est



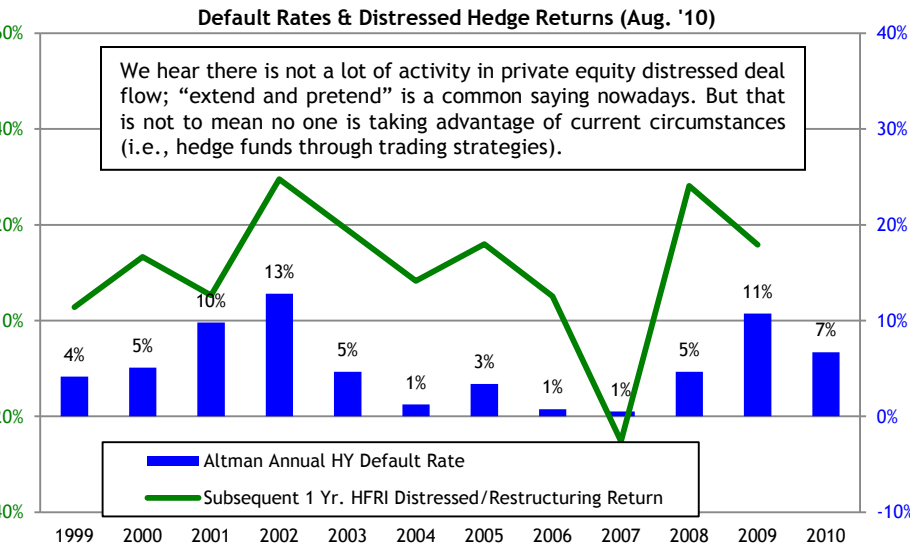
Source: FDIC

» Middle Market Mezzanine Debt Looks Attractive Nowadays

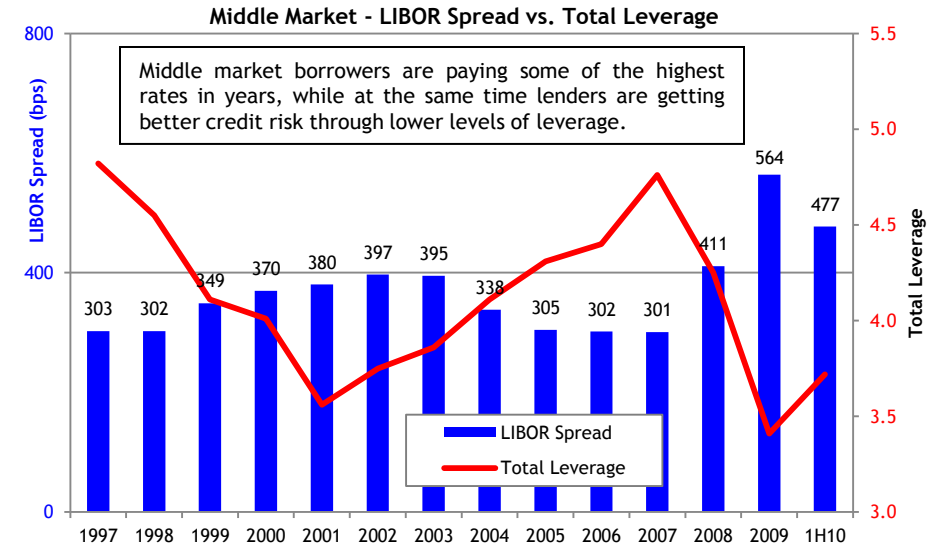
- Within private equity markets we see the biggest “fat pitch” to be middle market mezzanine lending in the current market environment.
- As opposed to just a few years ago, lenders are able to command far better loan covenants, are lending at lower levels of leverage, while at the same time getting higher rates of returns than in more than a decade.
- These strategies also appear to have an ample opportunity set over the next several years, and are offering investors a reasonable expectation of low teens returns, the majority of which is based on cash flows, which is ideal in choppy markets.
- Distressed debt has also gotten a lot of attention recently, but anecdotally we are not hearing or seeing much activity in this part of private markets, at least not for now.



Source: S&P LCD



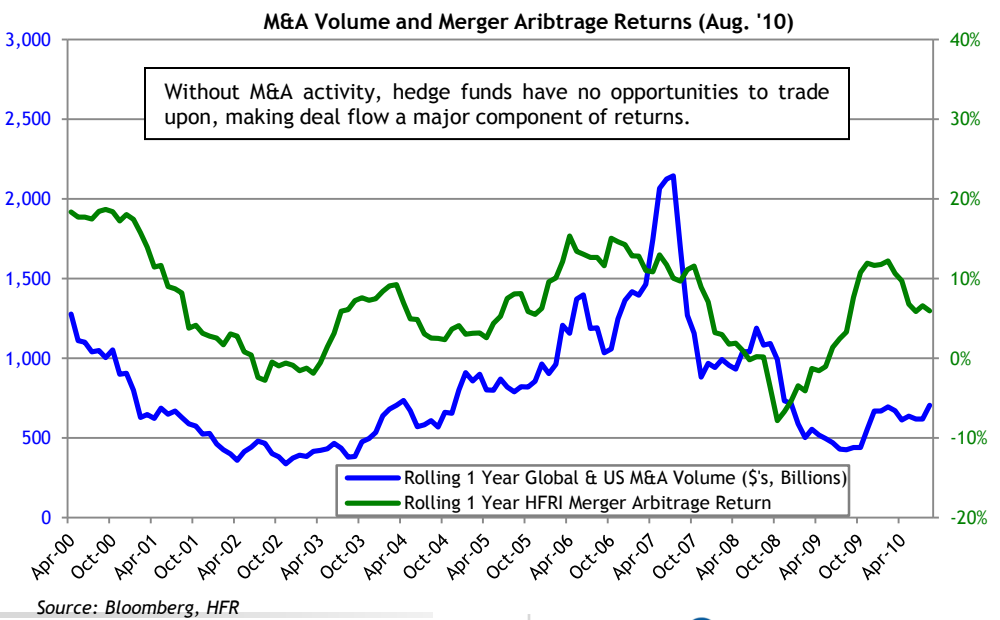
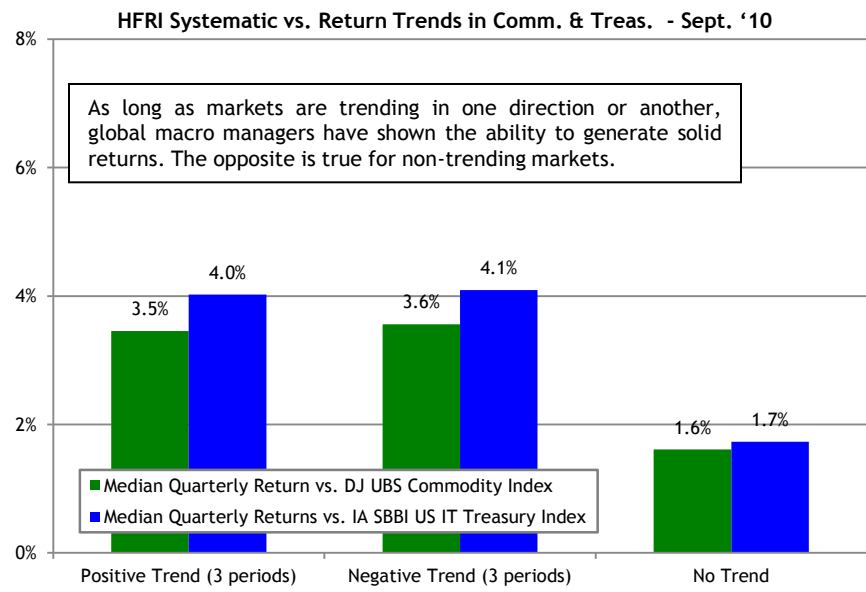
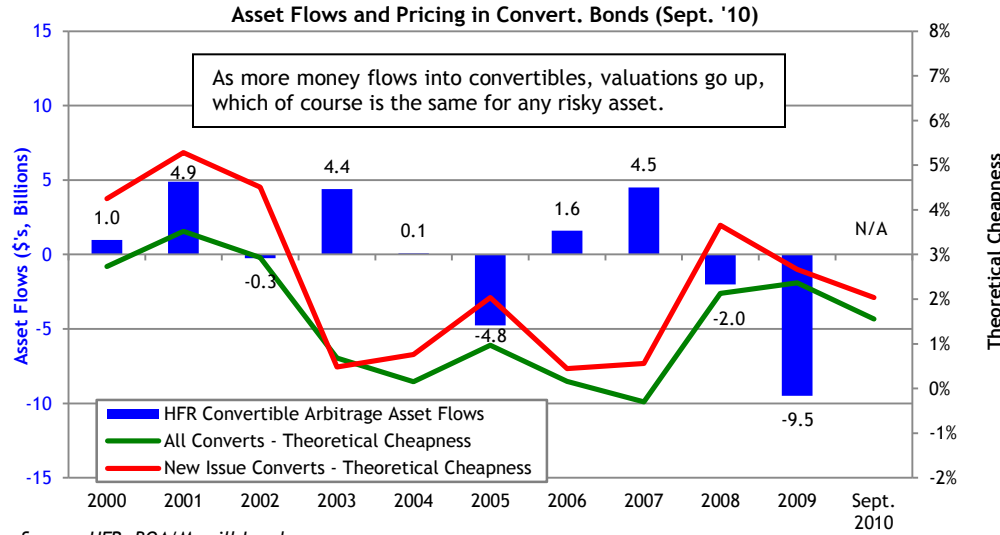
Source: Altman, HFR



Source: S&P LCD

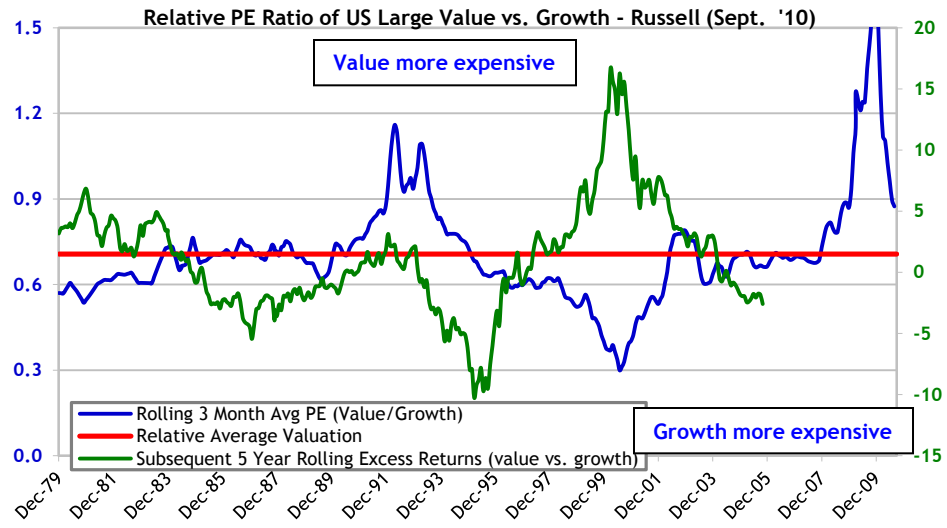
A Few Comments on Select Opportunities in Hedge Funds

- Within the space of convertible arbitrage, even though we do not yet have full 2010 data on asset flows, we can infer investors are allocating to this space based on a decline in the theoretical cheapness of these assets. With credit markets and volatility more stabilized, this only makes sense.
- From a top down point of view we can tie our macroeconomic and capital markets outlook into global macro trend following and merger arbitrage strategies.
- Trend followers need sustained trends to earn profits. Given our outlook of continued capital markets volatility, this may prove a challenging time for these strategies.
- Merger arbitrage funds likely stand to do well in the forthcoming environment. As mentioned earlier there is reason to expect greater M&A activity, which is key to returns.



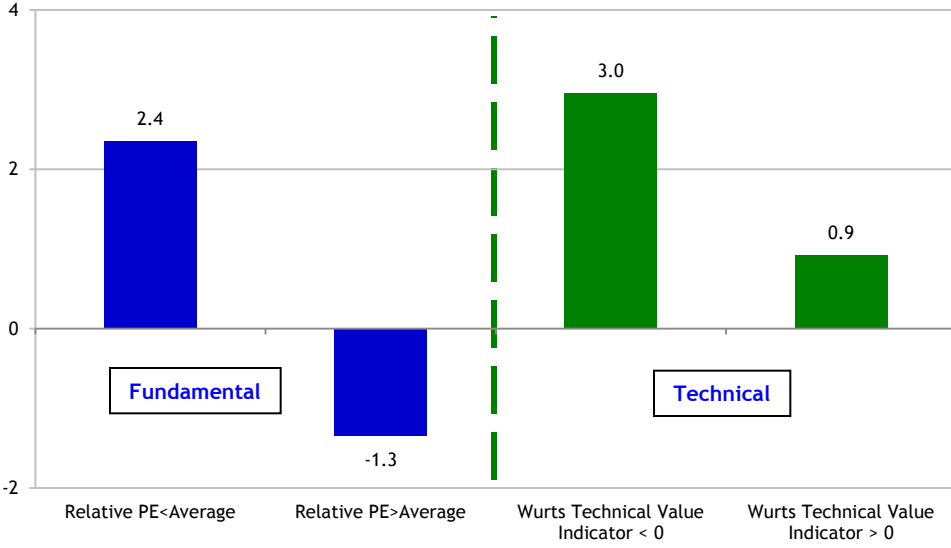
Style Tilts: US Large Value vs. Growth

- Dimensioning the attractiveness of style tilts became difficult during recent periods. This was primarily due to sharp declines in earnings and write offs for financial institutions which comprise a significant portion of the value universe.
- In fact, Russell PE ratios for US large value stocks reached as high as 45 towards the end of 2009, whereas growth stock valuations were half those levels.
- Valuation based analysis is becoming more meaningful as financial corporations repair their balance sheets. Nonetheless, value stocks do not appear cheap, which has been shown as being key to outperformance over time.
- On the other hand they do look attractive from a technical standpoint. So with conflicting indicators, no strong stance either way is warranted.



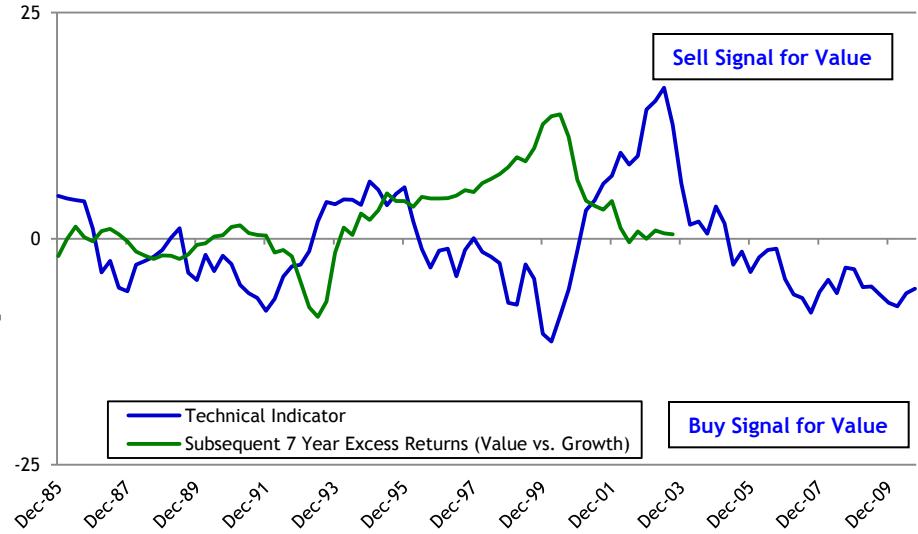
Source: Ibbotson, Wurts & Associates

Fundamental vs. Technical Indicators and Subsequent Performance



Source: Russell, Wurts & Associates

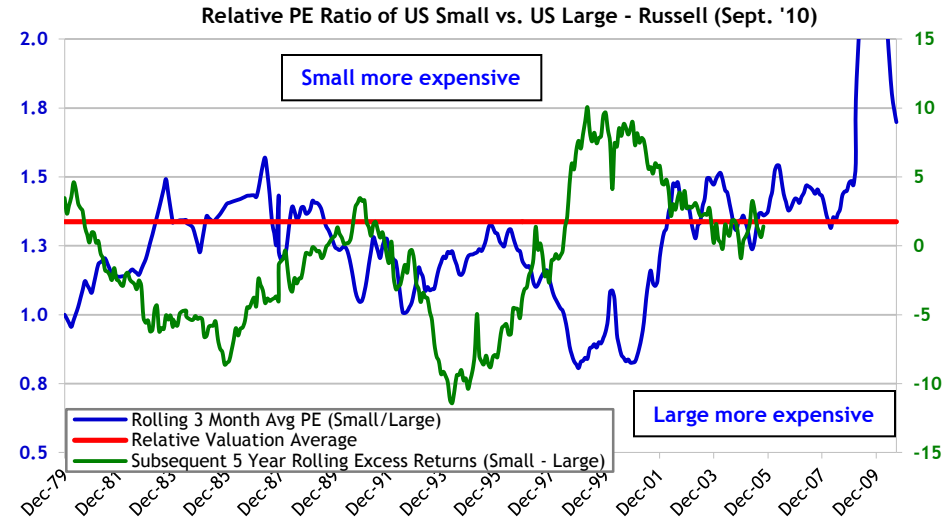
Technical Indicator for US Large Value vs. Growth - Russell (Sept. '10)



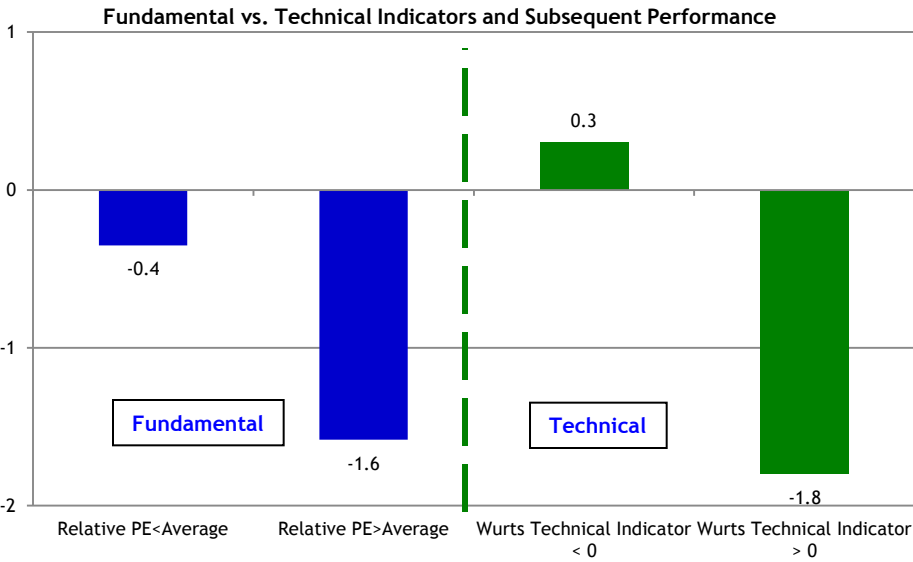
Source: Ibbotson, Wurts & Associates

Capitalization Tilts: US Small vs. Large

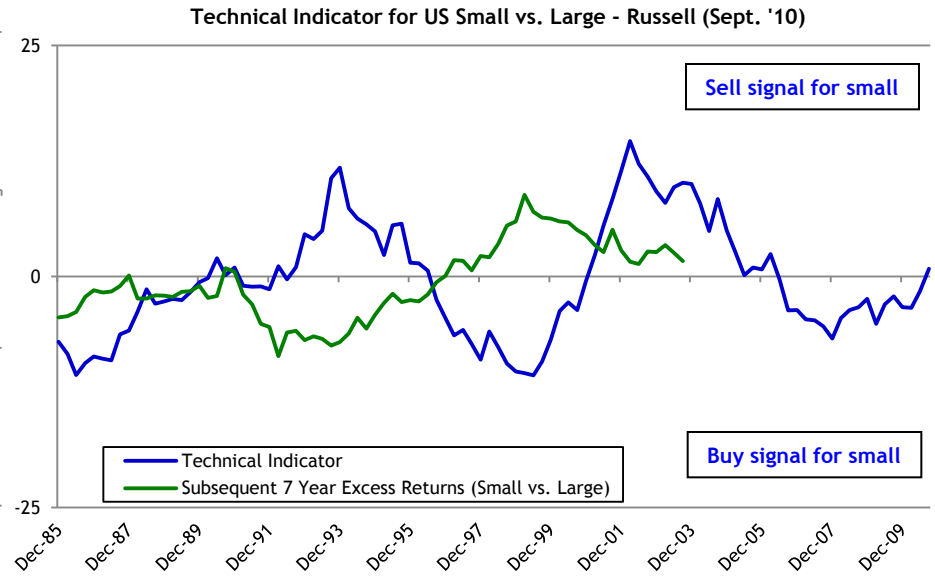
- A similar story of less meaningful valuation based analysis can also be told for US small cap stocks, which tend to have more volatile earnings, especially during times of stress.
- To illustrate this point, we would note Russell PE ratios for US small stocks were in excess of 100 for several months during 2009, but are now coming back to more normative levels.
- Buying small caps cheap is essential to realizing significant outperformance, which is not the case nowadays. Technical analysis is beginning to indicate small cap stocks seem oversold in relation to large caps. Nonetheless, given valuation and market volatility, caution in making tilts is warranted.
- However, a slight underweight seems prudent, as small caps do not appear cheap (or technically weak) enough to outperform large caps by a sufficient margin to justify the additional risk.



Source: Russell, Wurts & Associates



Source: Russell, Wurts & Associates



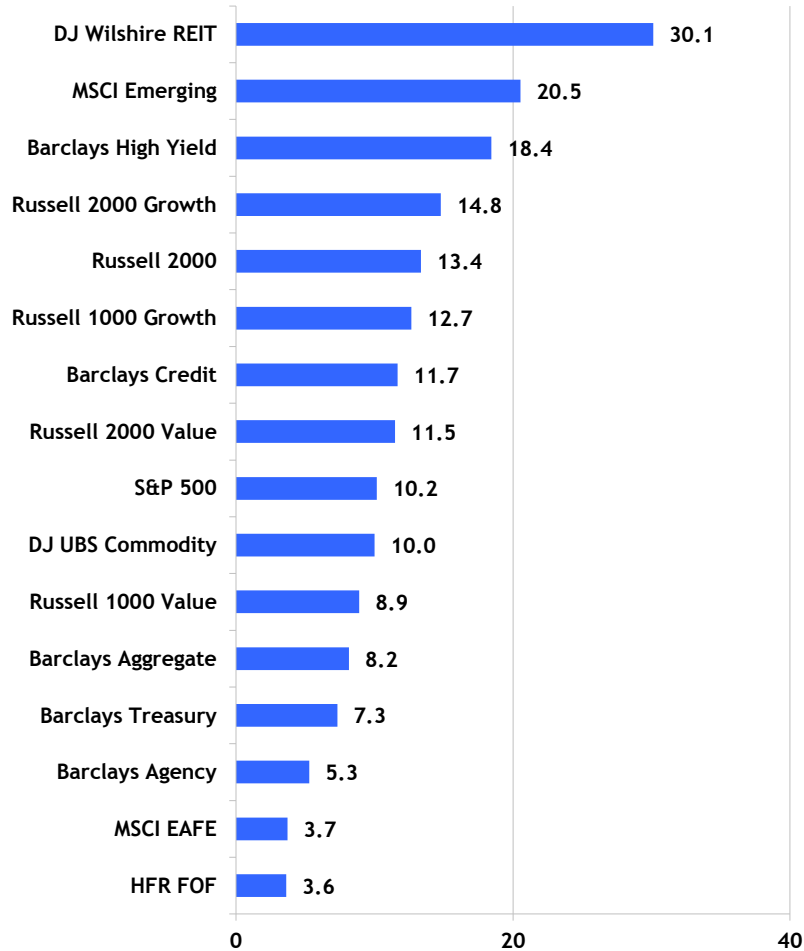
Source: Ibbotson, and Wurts & Associates



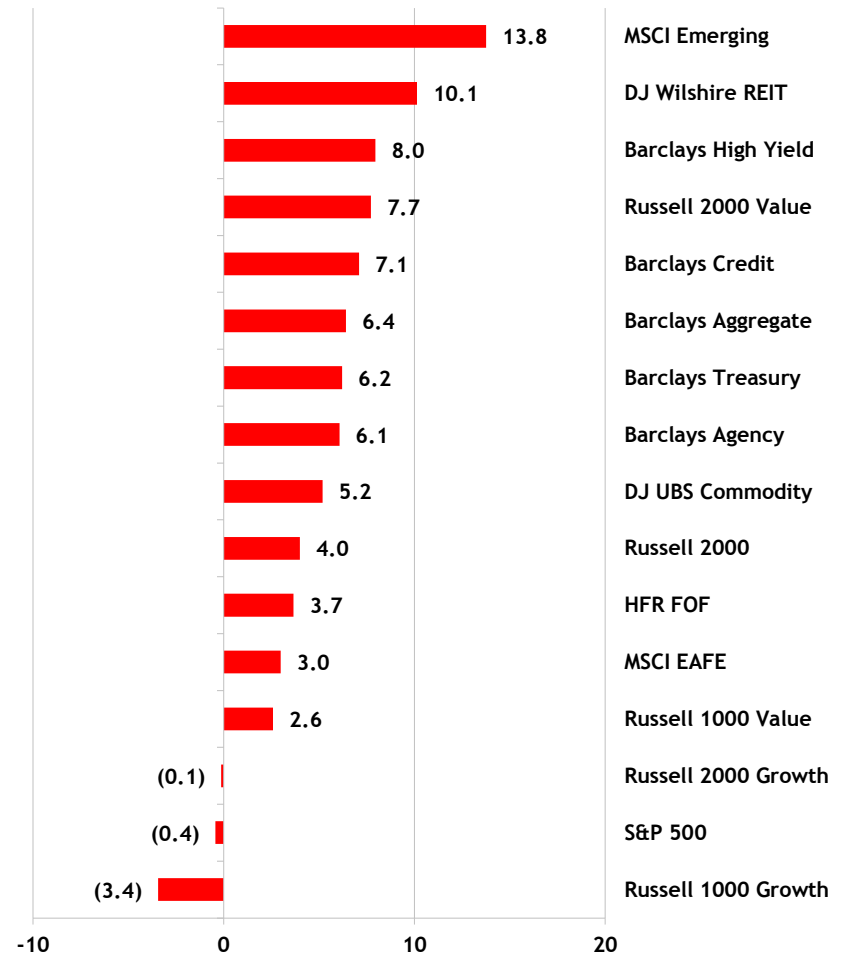
Appendix

Major Asset Class Returns

One Year ending September 2010



Ten Years ending September 2010



Periodic Table of Returns - September 2010

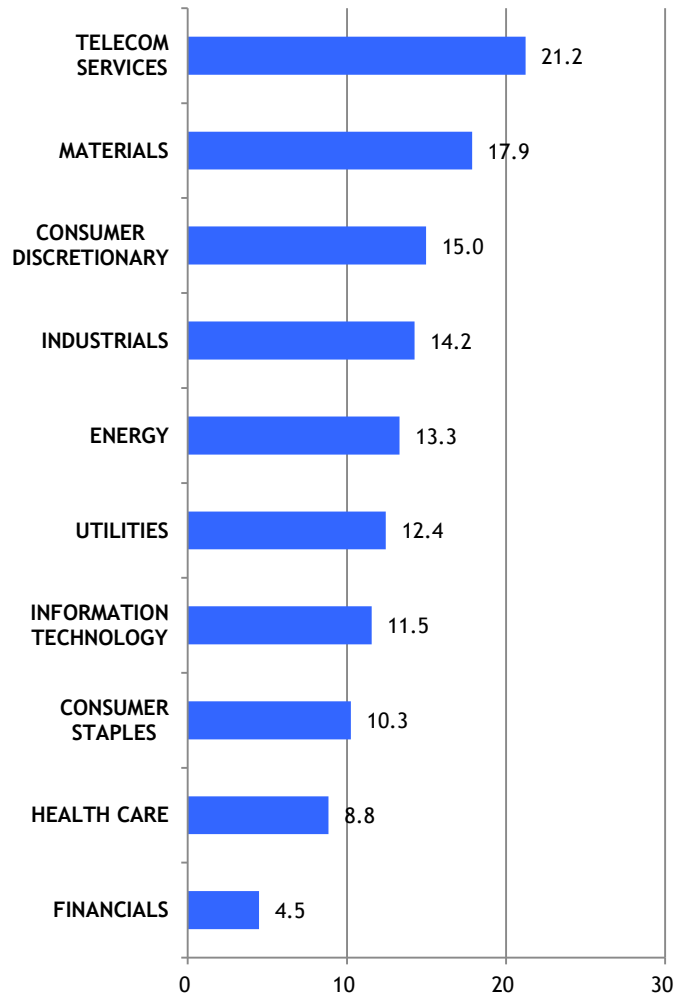
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 (YTD)
Best	65.0	17.5	59.9	29.1	74.8	8.1	38.3	23.1	35.2	38.7	66.4	22.8	14.0	10.3	56.3	26.0	34.5	32.6	39.8	5.2	79.0	11.0
	35.9	8.9	51.2	13.8	32.9	6.4	37.2	21.6	31.8	20.3	43.1	12.3	8.4	6.7	48.5	22.3	18.9	26.9	15.8	1.8	37.2	10.2
	25.2	7.9	41.7	12.3	26.3	4.2	31.0	21.4	30.5	16.2	33.2	11.6	7.3	1.7	46.0	20.7	14.0	23.5	11.8	-6.5	34.5	8.1
	20.2	2.6	41.2	11.4	23.8	2.7	25.8	14.4	18.6	15.6	27.3	7.0	4.1	1.0	38.6	16.5	7.5	22.2	11.6	-20.7	32.5	7.9
	18.8	2.3	24.6	8.0	18.1	-0.8	24.6	14.1	16.2	13.6	26.5	6.0	2.8	-6.0	30.0	14.3	7.1	16.1	10.3	-24.0	20.6	7.9
	14.5	-0.3	21.7	7.8	13.4	-1.5	18.5	11.3	13.9	8.7	13.0	4.1	-2.4	-8.6	29.7	13.1	7.1	13.4	7.9	-28.9	19.7	6.6
	12.4	-8.1	16.0	7.4	11.5	-2.0	11.6	10.3	12.9	5.1	11.4	1.9	-2.7	-11.4	21.6	11.1	5.3	12.8	7.1	-36.9	19.4	4.5
	10.8	-10.6	14.5	5.0	9.8	-2.4	11.1	6.4	9.7	1.2	7.3	-14.0	-5.6	-15.5	11.6	6.9	4.7	10.4	7.0	-38.4	11.5	4.4
	8.6	-17.4	12.5	3.6	3.1	-2.9	7.5	6.0	5.3	-5.1	4.7	-22.4	-9.2	-15.7	9.0	6.3	4.1	9.1	4.7	-38.5	5.9	2.1
	7.8	-21.8	5.8	-4.3	2.9	-3.5	5.8	5.3	2.1	-6.5	-0.8	-22.4	-20.4	-27.9	4.1	4.3	3.0	4.8	-0.2	-43.1	0.2	1.5
Worst	N/A	-23.2	-5.6	-11.9	1.4	-7.3	-5.2	3.6	-11.6	-25.3	-1.5	-30.6	-21.2	-30.3	1.1	1.2	2.4	4.3	-9.8	-53.2	-16.9	0.1

- Large Cap Growth US Stocks (Russell 1000 Growth Index)
- Large Cap Value US Stocks (Russell 1000 Value Index)
- Small Cap Growth US Stocks (Russell 2000 Growth Index)
- Small Cap Value US Stocks (Russell 2000 Value Index)
- International Stocks - Developed Markets (MSCI EAFE Index)
- International Stocks - Emerging Markets (MSCI Emerging Market Index)
- Hedge Fund of Funds (HFRI Fund of Funds Composite Index)
- Domestic Fixed Income (Barclays Capital Aggregate Bond Index)
- Real Estate (NCREIF Property Index)
- Cash (Citigroup 3-Mo Treasury)
- ICC Universe Median (Total Funds)

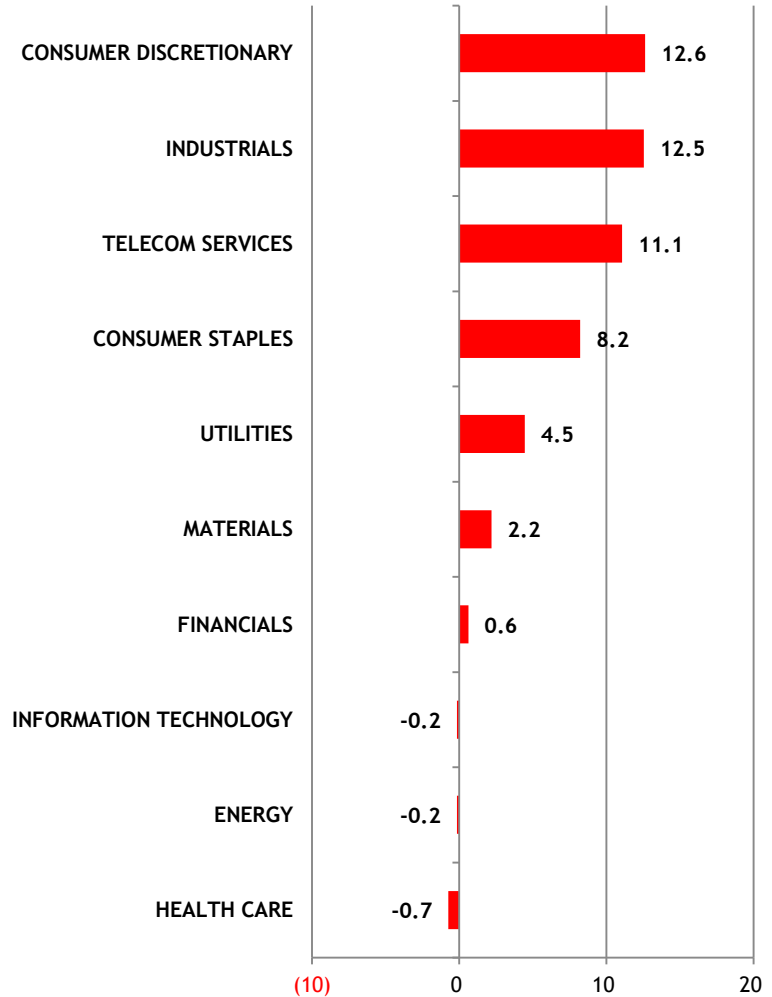
Data: Morningstar, Inc., Hedge Fund Research, Inc. (HFR), National Council of Real Estate Investment Fiduciaries (NCREIF) and Independent Consultants Cooperative (ICC).

» S&P 500 Sector Returns

Quarter Ending September 2010



YTD Ending September 2010



» Detailed Equity & Fixed Income Returns

Domestic Equity	3Q	YTD	1-Year	3-Year	5-Year	10-Year	Fixed Income	3Q	YTD	1-Year	3-Year	5-Year	10-Year
<u>Core Index Performance</u>							<u>Index Performance</u>						
S&P 500	11.3	3.9	10.1	(7.2)	0.6	(0.4)	BC US Aggregate Bond	2.5	7.9	8.2	7.4	6.2	6.4
S&P 500 Equal Weighted	12.7	8.8	15.8	(3.0)	3.0	5.5	BC US Treasury US TIPS	2.5	7.0	8.9	6.9	5.5	7.5
DJ Industrial Average	11.1	5.6	14.1	(5.4)	3.1	2.5	BC US Treasury Bills	0.1	0.2	0.2	1.3	2.7	2.5
Russell Top 200	10.8	1.9	8.1	(7.8)	0.2	(1.9)	<u>Maturity Evaluation</u>						
Russell 1000	11.6	4.4	10.8	(6.8)	0.9	(0.2)	BC US Treasury 1-3 Yr	0.6	2.6	2.6	4.1	4.4	4.2
Russell 2000	11.3	9.1	13.3	(4.3)	1.6	4.0	BC US Treasury Interm.	2.3	7.2	6.5	6.8	5.9	5.6
Russell 3000	11.5	4.8	11.0	(6.6)	0.9	0.1	BC US Treasury Long	5.2	19.1	12.7	10.8	7.8	8.2
Russell Mid Cap	13.3	11.0	17.5	(4.2)	2.6	4.9	<u>Issuer Performance</u>						
<u>Style Index Performance</u>							BC US Agency Intermediate	1.4	4.7	4.8	6.2	5.7	5.8
Russell 1000 Growth	13.0	4.4	12.7	(4.4)	2.1	(3.4)	BC US Credit	4.7	10.5	11.7	8.3	6.5	7.1
Russell 1000 Value	10.1	4.5	8.9	(9.4)	(0.5)	2.6	BC US MBS	0.6	5.1	5.7	7.5	6.4	6.3
Russell 2000 Growth	12.8	10.2	14.8	(3.7)	2.3	(0.1)	BC US Corporate High Yield	6.7	11.5	18.4	8.7	8.4	8.0
Russell 2000 Value	9.7	7.9	11.8	(5.0)	0.7	7.7	BC Emerging Markets	8.1	14.3	17.0	10.1	9.1	10.8

International Equity	3Q	YTD	1-Year	3-Year	5-Year	10-Year
<u>Broad Index Performance</u>						
MSCI EAFE	16.5	1.5	3.7	(9.1)	2.4	3.0
MSCI AC World ex US	15.9	1.5	4.9	(9.9)	1.6	2.0
MSCI Emerging Mkts	18.2	11.0	20.5	(1.2)	13.1	13.8
MSCI EAFE Small Cap	16.8	7.1	5.8	(9.1)	(0.1)	5.3
<u>Style Index Performance</u>						
MSCI EAFE Growth	16.0	2.2	6.1	(10.5)	0.6	(0.8)
MSCI EAFE Value	15.6	(4.7)	(4.8)	(13.8)	(2.1)	1.0
<u>Regional Index Performance</u>						
MSCI United Kingdom	19.8	2.6	9.7	(9.5)	1.5	3.0
MSCI Japan	5.9	3.1	0.2	(9.9)	(2.4)	(1.7)
MSCI EM Asia	14.7	9.1	16.3	(5.1)	10.7	9.7
MSCI EM Latin America	20.4	6.4	18.8	1.9	15.9	15.9