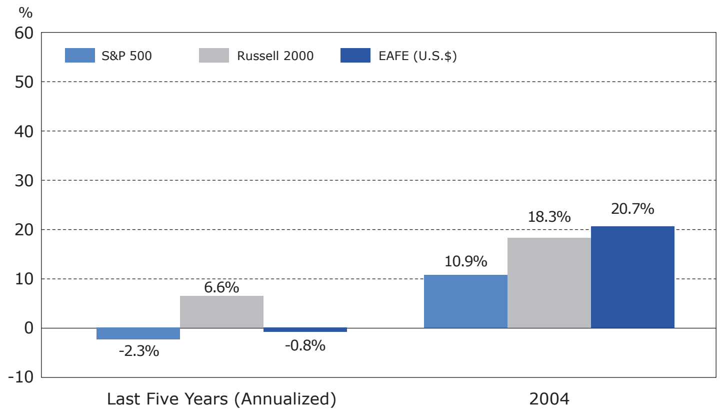
Gresham Partners, LLC
2005 Market Outlook

Stock markets enjoyed an above average year in 2004, thanks to a surge in the fourth quarter. For the year, stock markets were led by energy and basic materials companies, reflecting a surge in oil and commodities prices, and industrial companies riding the profit expansion. Many larger, high-quality, consumer-oriented companies disappointed, especially the drug companies, as did technology.

World equity markets have now rebounded by over 50% in the last two years. Excluding technology, media, and telecom, world markets have now exceeded their previous highs. For the first time since 1986, foreign stocks have outperformed U.S. stocks for three consecutive years. Value outperformed growth again in 2004, but the margin was much smaller than in the prior several years.

Bond markets surprised investors by performing "normally," with the 10-year treasury yield unchanged year over year. Among alternatives, commercial real estate provided another good year, with cap rates falling and prices rising. Hedged strategies provided below normal returns, as expected, and private equity continued its recovery.



In the near term, we reside in a tug-of-war between the forces of reflation and deflation, especially in the U.S. The forces of reflation, primarily high levels of fiscal and monetary stimulus, are subsiding as the Fed raises short-term interest rates and the U.S. government begins to face the task of curbing its fiscal and trade deficits. The forces of deflation restrain the outlook and include high debt levels in the face of rising interest rates, the possibly tiring U.S. consumer, and the continuing pressure of international competition. Overall, the world is suffering from a lack of aggregate demand, as the baton impelling the world needs to pass from the U.S. and China to a more even distribution of demand around the world. Most seers believe that reflation eventually wins this battle, but the progress is expected to be slow given the strength of the opposing forces. The result is that many economists see a reduced rate of growth in real U.S. GDP of 2%-3.5% in 2005 with inflation adding another 3% or so to comprise nominal GDP.

With the U.S. consumer accounting for 70% of GDP in 2004, it is important to put the consumer in perspective. The U.S. consumer never retrenched in the recent recession, and as a result the usual bounce in consumer spending did not occur. In this cycle, the consumer has been a more neutral force and can likely be expected to remain so. While much has been made of high consumer debt levels, it is estimated that 75% of consumer debt is mortgage debt at low fixed rates and variable rates remain low for now. Although job growth has been somewhat disappointing, nearly 95% of the working population is employed. Wage rates were about flat in 2004 in real terms, but longer hours were worked, so income is up, and real wage rates are expected to rise at some point. At this point, a retrenchment by the consumer does not seem likely, but neither does the consumer seem a likely impetus of higher economic performance.

The corporate side of the ledger is more interesting and a more likely source of growth. U.S. corporations have enjoyed one of the largest expansions of corporate profits in history. Profit margins are near all-time highs at nearly 8% of GDP. Balance sheets have been repaired, and cash

Overview

Our big picture themes remain unchanged. We continue transitioning through an adjustment to a confluence of major reversals of prior trends:

- One of the greatest bull stock markets and capital spending booms in history ended in 2000. The unwinding of excesses continues.
- A long-term governmental policy of disinflation fueled a 20-year bull market in bonds, which bottomed in mid-2003.
- A realignment of nations along diverging national interests is underway, and geopolitical risks have risen sharply. This follows an unusually stable and quiescent period of unipolar domination by the U.S. in the 1990s, following the end of the cold war. The degree to which increased international tensions will affect the trend toward globalization and free trade is unknown.

Changes of this magnitude and along these many dimensions create a period of heightened systemic risk and will take years to play out. In this transitional environment, outcomes are harder to predict and control, policy decisions are more subject to error, and the consequences of mistakes are more volatile. Logically, financial markets should reflect increased risk and less predictable outcomes through higher volatility and lower valuation.

levels are near 30-year highs in relation to corporate spending budgets and as a percent of assets.

But corporations remain cautious. Many are still working off the excess capacity and other excesses of the 1990s. Reinvestment in their businesses through capital spending and hiring is growing, but restrained. Lean balance sheets and cash holdings could also be used to purchase other faster growing corporate assets, but the level of corporate transactions is only recently showing signs of increase. Neither do corporations seem to be finding additional value in the prices of their own companies, as stock buy back programs, although at a very healthy rate, are not yet increasing significantly. This restrained use of corporate resources will likely reduce profit growth going forward.

Perhaps what we are seeing in corporate behavior is the long awaited upward adjustment in risk premia for the riskier and more uncertain environment that we see going forward. While investors have expected to see a higher risk premium reflected in a lower valuation for equities, perhaps we are first seeing it in corporate behavior, leading to more conservative corporate actions and resulting in lower expectations for economic and profit growth. At some point, these lower expectations feed through to equity markets and result in lower valuations.

Monetary policy in the U.S. has diverged from that in most other countries. In the U.S., the Federal Reserve has launched a process of slow but steady increases in short-term interest rates. Many economists expect to see short rates reach the 3%-4% range in 2005. By contrast, central banks (other than Japan's) never reduced rates to the degree the Fed did, and are likely to maintain much easier monetary conditions than in the U.S. in the face of slower demand overseas. Thus, while the U.S. will face the head winds of less accommodative monetary and fiscal policy, other countries will enjoy more benign macro conditions.

In general, most economists believe that worldwide economic conditions will remain positive, fueling growth in GDP and corporate profits around the world, although at a slower pace. Such trends tend to be self-reinforcing, with improving corporate performance ultimately leading to additional jobs, resulting in increased spending, and so on.

Some comment on the dollar is in order given the near universal view that the dollar will decline against foreign currencies for the indefinite future and the importance of the dollar. At year end, the dollar had dropped about 16% from its prior peak in 2002 on a trade weighted basis. At this point, the dollar is no longer very expensive on a purchasing power parity basis. However, the U.S.'s huge trade deficit creates conditions in which U.S. consumers buy imported goods with dollars that exporting foreign countries are currently reinvesting in U.S. assets, primarily U.S. bonds. Some have likened this to a giant vendor financing scheme, in which it is in the interest of both U.S. buyers and the foreign vendors to continue the process as they try to manage down the problem through a lower value for the dollar. A lower value dollar should increase U.S. exports and reduce consumer demand for imports over time, thus reducing the trade deficit. The burden of the U.S. "debt" taken on to finance the deficit is moderated by paying in cheaper dollars. The result would be a continuing decline in the dollar over the next few years, interrupted by periodic rallies.

While this process will likely work, and it is in the interest of all parties that is does work, it will require higher overseas demand relative to that of the U.S. The imbalance was caused in the first place by higher related economic growth and demand in the U.S. Given the demographics of the leading foreign countries (aging and slower growing), this could be problematic. Some feel that the gap in growth rates and demand will not close until the U.S. enters its next recession. In the mean time, there is almost universal expectation that the dollar will overshoot on the down side sometime over the next few years.

Good performance in most asset markets in 2004 has further reduced risk premiums across the range of asset classes, thus increasing our concern about heightened risk in the face of limited return potential. Moreover, a repricing of risk usually occurs as the reflationary process proceeds, as interest rates and inflation rise. In contrast, asset markets appear complacent. Credit spreads in fixed income markets remain near historic lows. In stock markets, opinions vary on whether the market is fairly priced or over priced, but no one thinks it is under priced. In the face of this, it is widely expected that economic and profit growth will decline to lower levels, that interest rates and inflation will increase, and that fiscal stimulus will decline. Historically, these have been conditions when credit spreads widened, price earning ratios fell, and volatility increased as liquidity deteriorated.

Thus, while the economy appears to be poised to perform adequately, we are not so sure about financial markets. As one commentator noted, you don't get rich by fighting the U.S. economy, as it often turns out to be more robust and resilient than forecast. But if you are already rich, you stay rich by avoiding over priced assets.

U.S Equities

For 2005, securities analysts are projecting a 10% increase in operating earnings for the S&P 500, following an increase of about 20% in 2004. The long term average is about 8%.

The S&P 500 was trading at 16-17 times projected 2005 earnings at year end. The 50 year average for P/E ratios on forward earnings is about 15, although these data mix reporting and operating results. In more recent years, when operating data were used, the forward average is about 12 times.

Earnings and valuation levels are somewhat confused given the current dominance of financials in the S&P 500, accounting for over 20% of the index and over 35% of projected earnings for 2005. Major financial institutions have migrated to a more levered and trading oriented posture, and they have historically not performed well in a period of rising interest rates and a flattening yield curve. As result, the "quality" of earnings and valuation data may be more questionable than normal. Financials trade at below market multiples, dragging down the reported P/E ratio of the index.

The best hope for stock market performance in 2005 seems to rest on the assumption that market multiples can remain at current levels and stock prices can increase along with earnings at 8%-10%. Prior estimates for much faster earnings growth have essentially vanished, as the reality that profit growth substantially in excess of historical trend is unlikely in view of moderate GDP growth potential in the U.S. Even these modest expectations could fall short if markets price in an increase in risk and valuations fall. One of Gresham's managers has called his expectation for modest progress in 2005 as "a year of living dangerously."

As mentioned in our last report, larger, higher quality companies have become relatively cheap in today's stock market. The top 25 companies in the S&P 500 are at a 20-year low in terms of their valuation relative to the entire index. This might suggest greater investment in larger, higher quality companies, and even in indexing. However, there are also other factors that play. First, some of these companies face societal constraints on their growth, for example, Wal-Mart and Microsoft. In addition, the drug companies face difficult regulatory and pricing problems. Finally, a number of very large financial institutions contain leverage and a trading oriented posture that may be deserving of lower valuation. At present, we see larger U.S. companies as an asset class as relatively inexpensive, but not very interesting. We will leave the question of greater investment in such companies in the better qualified hands of our active managers who will select them on a company-by-company basis when they are attractive.

Another striking feature of the current market is the compression in P/E ratios. The differential in valuation between the most expensive and least expensive companies is near a historic low. In part, this reflects the catch-up in valuation, and perhaps over valuation, of value and lower quality stocks over the past few years. In addition, smaller companies have greatly out performed their larger brethren, especially value and lower quality companies. In a less buoyant economic environment, value, lower quality and smallness may do less well as they are typically more highly leveraged to economic growth (declining), less exposed to international sales (rising), and disproportionately hurt by increased volatility (possibly rising). For us, this condition emphasizes the fact that stock picking has become both harder and more important as generic market returns are likely to be modest and stock specific risks have increased.

Foreign Equities

Foreign markets outperformed U.S. markets for a third consecutive calendar year in 2004. The decline of the dollar provided about eight percentage points. Asia and Europe performed about comparably. As in the U.S., small and mid cap companies generally outperformed and emerging markets were the winner, up about 26%.

Our preference for foreign equities over U.S. equities remains strong.

- The valuation gap between developed foreign markets and those in the U.S. remains unusually large. The gap is largest in Europe. In Asia, valuation levels are similar to those in the U.S., but most Asian countries are expected to grow faster that the U.S.

- Especially in Europe, macro conditions are expected to diverge from those in the U.S., with monetary conditions being substantially more benign as their central bank seeks to encourage faster economic growth.

- Also, in Europe, the forces of globalization are in the process of forcing serious structural and labor reform, which has caused labor and other costs to drop disproportionately to those in the rest of the world. Effectively, European profits could diverge positively from their slower growing economic trends.

- Foreign companies generally lagged the U.S. companies in productivity increases, in part due to lesser investments in technology, and some catch-up is possible. As a result, margins have the potential to increase overseas.

- Dividend rates are higher overseas. In Europe, they are now not much lower than intermediate bond rates.

- A falling dollar will increase the return on foreign stocks to a U.S. investor, although the long-term effects of the falling dollar will dampen growth overseas.

- Higher levels of mergers and acquisitions show serious efforts to restructure and create greater corporate efficiency.

We have believed for some time that we could be in a multi-year period of relative out performance for foreign equities, and we believe that we are part way through that period. We add that foreign equities are not cheap in absolute terms, but they are closer to historical valuation levels than U.S. equities.

Bonds

Bond markets surprised most investors in 2004 as rates remained flat year over year and bond markets provided normal returns. Investors had expected increased yields and inflation with resulting declines in bond markets. Credit spreads, reflecting the yield differential between treasuries and lower quality credits, declined to the lowest levels in ten years.

For the year, intermediate treasuries returned over 4%, and municipals returned about 3%. Lower quality credits performed better given declining yield spreads. Corporates returned almost 5%, while high yield bonds and emerging market debt provided 11%-12%. Inflation protected bonds returned 8%.

Like many investors, we have been negative on the bond market for some time. We believe the 20 year bull market in bonds ran its course in 2003 and interest rates and inflation are now in a rising trend. With real short-term interest rates still negative, credit spreads at very low levels in the face of increasing interest rates and inflation and a flattening yield curve, investor complacency is evident. As Alan Greenspan said recently, “Those not prepared for higher rates must be desirous of losing money.”

Moreover, while corporate balance sheets have been repaired and corporate cash positions are very high, we are likely through the phase of bond friendly corporate actions to strengthen balance sheets further. Now, however, corporations are likely to turn to actions increasing return on equity to reward shareholders, including greater capital spending, acquisitions, greater share buy-backs, and dividend increases.

Lastly, and on a longer term basis, we believe the decoupling of ownership and accountability for risk assessment created through the growth of conduit asset-backed financing has impaired the quality of risk analysis in the bond market, as loan originators no longer retain such loans as investments. These risks are heightened by Wall Street’s tranche structuring of these investments to create derivatives whose risks are very difficult to assess.

We continue to believe that distressed debt investing is relatively attractive. Smaller, lesser known credits that are working their way through bankruptcy and restructuring in an era of improving economic conditions can present attractive opportunities to experienced and knowledgeable investors. While interest rate trends may be negative, it is really the assessment of the credit and business elements of these issues that are critical to their investment success, not interest rates.

Real Estate

Year-over-year returns for privately held, unlevered, core real estate properties were estimated at about 12% through September, the most recently published data. This reflects real estate’s substantial current yield plus appreciation of about 5% on an annual basis. REITs increased 23% for 2004.

Operating trends for most properties remain poor. Although office vacancy rates have improved, effective rental rates remain below the level of recent years, which means that lease turnover results in lower effective income. These reductions are built in with the term of each new lease, and it will take a few years of increasing effective rent levels to turn operating income upward. Retail properties are a continuing exception, as consumer spending never declined, and retailing properties have continued to show high occupancy levels and increasing income. Hotels are in the best trend as they are strongly correlated to improving economic trends, and there is little supply in the wings. Multi-family properties are plagued by low rental rates and continuing supply problems as construction of single family homes and for-rent properties continues to exceed demand. Bright spots in multi-family include the demographics associated with student housing and senior housing.

In contrast, capital markets favor real estate. The prices of substantially leased, high-quality malls and well-located downtown office properties in popular markets remain at high levels on a per square foot basis, and cap rates declined further over 2004. Real estate’s popularity reflects the fact that it is very competitive with other asset classes in today’s low return environment given its stability and relatively high current return. Also, the very low interest rate environment and easy lending conditions have been helpful to real estate, as they allow a high degree of positive leverage to be applied to enhance both the current and the capital return of real estate.

Real estate may also be in a positive secular trend as it moves from a marginal asset class into greater acceptance as a mainstream investment area. This has been supported by increasing transparency as well as more active and liquid markets, although the asset remains inherently illiquid. This development is not limited to the U.S., as greater understanding of the legal and political framework in which real estate assets are acquired and owned has led to greater cross-border real estate investing.

Significant increases in interest rates will have a negative effect on real estate pricing, as positive spreads between borrowing rates and real estate yields have pushed real estate prices up and cap rates down. Positive leverage will likely be roughly neutralized at a 10-year treasury rate of about 5%. However, the effect on cap rates will be mitigated by real estate's hybrid nature, partially reflecting underlying leases and partially reflecting a real tangible asset, which responds positively to increasing inflation.

With interest rates expected to rise slowly, and given our expectation for a continuing low return world, real estate pricing could remain elevated for some time. Given the inefficient and property specific nature of real estate investing, this presents the opportunity to find underdeveloped or unrecognized opportunities that can be improved and properly marketed in this attractive market for sale, almost as a kind of arbitrage. For this reason, we are relatively positive on real estate investing in the intermediate term. In the longer term, the expanding economy is likely to eventually lead to increasing rents and operating income, and we expect real estate to continue to gain traction as a mainstream asset class, both in the U.S. and overseas.

Public markets for REITs have been one of the best performing sectors of U.S. equity markets for the last three years. Our real estate advisors believe that REIT prices have been driven up by their substantial current yield and the market's perceptions of the stability of those yields, despite deteriorating trends in underlying real estate operations. This suggests caution.

Hedged Strategies

Although hedge fund indices are seriously flawed and must be viewed as more anecdotal than factual, they indicate hedged strategies likely returned 6%-7% in 2004. We have been expecting hedged strategies returns to fall into the high single digits for some time.

The level of interest in hedge funds as a sort of cure-all for lower expected returns and high volatility in traditional markets has assumed faddish proportions. Some feel it resembles the portfolio insurance fad prevalent a number of years ago in which prearranged portfolio sales were expected to prevent the possibility of major losses in a stock market decline. As is the case with most fads, once the idea became very popular, its effectiveness was destroyed.

While time does not allow a full discussion in this report, suffice it to say that most investors' expectations as to the benefits and returns from hedge funds are exaggerated. In part, this reflects the increasingly crowded field and the fact that a number of hedge fund strategies cannot accommodate large amounts of capital. Perhaps more importantly, it reflects the fact that current expectations were drawn from a period of once-in-an-era events favoring hedge funds. The extraordinary distortions and excesses of the late 1990s provided conditions such as valuation discrepancies of historic proportion among market sectors and investment styles, excess debt leverage, overly aggressive accounting, and outright fraud. Particularly for long/short equity hedge funds, it is unlikely that anything like these conditions would exist again anytime soon.

As an example of the effect of competitive conditions, consider the fact that several of the best established long/short managers are establishing long only portfolios. This reflects their difficulty in making money on the short side. As more competent traditional equity managers assume the hedge fund mantle by establishing a short side to their investment platform, the competition for short ideas becomes more intense. Remember, short selling was a dark corner of equity markets 10-15 years ago. In addition, particularly in smaller, less liquid securities where good long or short ideas are most likely to be found, competition increases the difficulty of borrowing the stock to establish and maintain short positions.

In order to accommodate their larger asset base, a number of the larger and better managed hedged funds have diversified their approach and moved further afield. Many have moved from a single strategy to multiple strategies. Some have moved into leveraged buy-outs or other forms of private equity and even into direct high yield lending. Some resemble a merchant bank.

This move toward greater diversity also reflects the risk to a manager of the high water mark aspect of incentive fees. Recall that if a hedge fund manager loses money for an investor, he must first recover the loss before he can earn additional incentive fees. If a significant loss is incurred, there is a risk that the professional staff, which often participates in the incentive fee, will jump ship to a manager who has no high watermark threshold to overcome before earning an additional incentive fee. Greater diversity lessens the risk of a major loss, but in general, this aspect of hedge fund management has a tendency to lead successful managers with large asset bases to become more conservative and less profitable.

Our expectation for hedged strategies remains for below normal returns. The large flow of money to hedged strategies is likely to lower returns for a sustained period. While we have exceeded our benchmark for hedged strategies of treasury bills plus 5% by a comfortable margin in the last ten years, our managers may be hard pressed to reach that benchmark in the next several years due to the amount of competitive capital at work in the field.

Despite the dour outlook, we remain interested in the area because we believe it attracts the most talented managers and that the long/short strategy is a powerful and potentially positive investment tool in the hands of the right manager. The challenge is to be sure one has a talented manager who has the understanding and ability to deal productively with the hedge fund format, including the risks of leverage and the unlimited loss potential of short selling. These managers are rare.

Private Equity

The venture capital industry remains in an improving phase as the pace of investment, although greatly reduced from the bubble years, continues to increase. Fund raising has grown even faster. Investment interest is highest in biotech, medical devices, and software. As the industry has stabilized, the emphasis has moved back into earlier stages of investing, with seed and early stage investing now comprising a more important component. Acquisitions and IPO's have provided a platform to establish valuation levels and exit strategies which were necessary to stabilize the industry.

Buyout funds have operated in a more favorable world. The recent period of corporate rationalization and delevering is a fertile ground for buyouts, and the prospect of increased corporate sales and profit growth should reward buyouts. Moreover, the lending environment has become quite favorable. The big problem for buyout funds now is the surplus of capital seeking investment, especially in the middle market. In the short run, some feel this has led to the recent spate of large transactions in which one LBO firm sells a company to another LBO firm. Some feel this amounts to an effort to deal with the large overhang of investor capital in the LBO market. It has been a particular benefit to middle market buyout firms that were selling into this phenomenon.

The surplus of capital in buyout funds has created intense competition for attractive buyout candidates, and this has lowered expected returns to a level which does not allow buyout funds to attain the high teens net returns to investors that has been their objective. This means that smart buying and financial engineering will not be enough. To meet their objectives, buyout funds must increasingly possess operational skills to enhance the value of a company to meet their objectives. They may also invest in smaller enterprises that they believe they can roll-up with similar investments or integrate a supply chain.

Summary

The U.S. and its global partners seem to have successfully reflated. As a result, the fundamental underpinnings seem to be in reasonable shape, although governments will be challenged in making the transition to more restrictive monetary and fiscal policies over the next 1-2 years. Fiscal reform is always difficult and requires political will and skill.

In investment markets, the situation is not as bright. We start from a point in which asset markets broadly remain fully valued in the face of the need to transition to less rapid economic growth, reduced profit growth expectations, higher interest rates and more restrictive fiscal policy. Geopolitical risks remain high as well. Such periods are typically difficult for equity markets in particular, and our expectation for the bond market remains long-term negative.

As a result, we have been expecting for some time that we would have to endure a multi-year period in which most asset classes may return less than historical norms, perhaps punctuated by sharp rallies and declines. Such periods can be frustrating and a time to remember one of Warren Buffett's many sagacious comments: "Investing does not require extraordinary intelligence, but it does require extraordinary temperament." We would add that perspective can also be helpful. Thus, while we would prefer a more attractive world in which to deploy our clients' capital, we cannot change the world in which we live. We must simply determine how best to profit from it, while remaining very conscious of the risks we must take in doing so.

In this environment, we are focused as follows:

- While cash might seem inviting, we are certain that attempts to move in and out of cash will provide poor results. Instead, we suggest staying relatively fully invested while remaining very risk conscious, relying on broad diversity and fundamentally sound and experienced management to mitigate risk.

- In selecting management across our diverse range of asset classes, we remain very fundamentally based. Taking stocks as an example, we think that wealth is created by businesses with sustainable earnings and asset values, not "stocks." Fair valuation must be based on the absolute price one pays for the underlying business in relation to its fundamental attributes. Stock prices are a faulty and dangerous gauge of value, except over very long periods, and it is important to avoid basing investment decisions on the relative value of stocks.

- We constantly upgrade the quality of management, seeking out best-in-class managers who can successfully operate in less efficient and less liquid areas where research is less intensive and where reasonable returns may exist even in a poor overall investment environment. Fortunately, the difficult period for equity values over 2000-2002 allowed us to approach some very successful managers who have been closed to new capital for some time. These managers provide long proven success and strong evidence of their responsibility to investors, which they have shown by closing. For Gresham and its clients, a closed manager presents an opportunity, since they often remain open to stable, knowledgeable, and low-maintenance investors, such as our clients.

- Foreign stock markets remain more attractive than U.S. markets, and we have placed increasing emphasis there. We continue to diversify management.

- As our view of the bond market turned increasingly negative over the last two years, we reduced risk first by lowering average maturities, and in 2003 we reduced bond allocations for our clients generally. Within bond markets, we continue to prefer distressed debt, really as an equity substitute.

- While the divergence between operating fundamentals and pricing for real estate remains worrisome, real estate markets are perhaps the most inefficient of major asset classes and are very property specific in nature. We believe our real estate managers will continue to be successful in this inefficient market, finding a small number of discrete opportunities that can provide returns well above those of the real estate markets generally.

- Our expectations for hedged strategies returns remain below normal, but the hedge fund industry continues to attract some of the best talent and the hedge fund format provides the right manager with powerful investment tools. Coupled with the relative stability of hedged strategies, this makes them a continuing attractive strategy in uncertain financial markets.

- Private equity markets have stabilized and could provide attractive opportunity if the excess of capital and players do not overwhelm available investment opportunity. In this environment, we hope to become more active on behalf of our clients in seeking investment opportunity.