

Gresham Partners, LLC

Annual Outlook 2009

The credit crisis continues to erode the global economy at an accelerating pace. Governmental authorities are responding aggressively in an effort to thaw credit markets and avoid a severe and prolonged recession. While we are seeing signs of the banking system stabilizing and market volatility subsiding, we still face the question of whether these efforts will ultimately succeed. The range of possible economic and market outcomes remains wide, mandating a cautious approach for risk conscious investors such as ourselves. During this difficult period, we remain focused on limiting losses and protecting against permanent impairment of capital.

The U.S. economy is now officially in recession. While chapter one of the downturn revolved around the credit and banking sectors of the economy, chapter two is clearly centered on the consumer. Consumer confidence and spending appears to be in the early stages of a secular decline. Over the last 20 years, consumer spending increases came largely from increased borrowing, a trend that will likely unwind over some longer period. This is particularly troublesome since consumers account for roughly 70% of the U.S. economy. Additionally, there is a real concern that the fiscal and monetary tools of the past will be less effective in stimulating demand during this crisis, increasing our concern that this problem may simply be too large for government authorities to solve quickly.

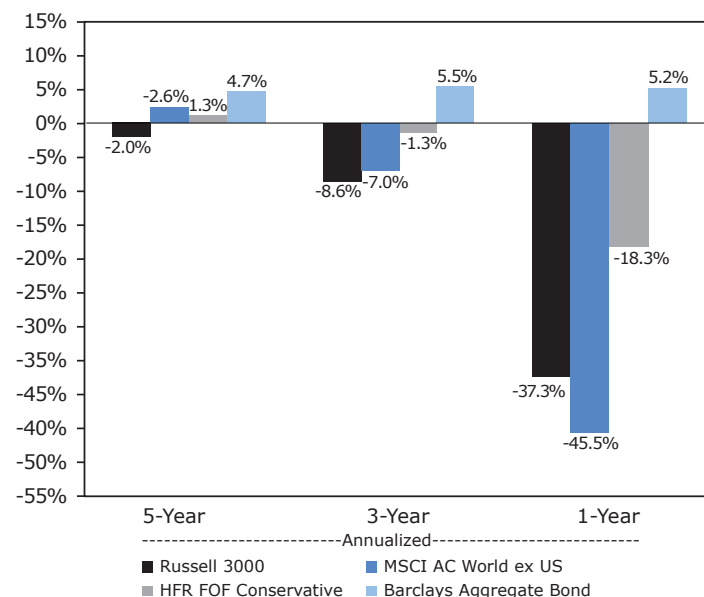
While the longer-term picture is still unclear, we believe a reordering of global economic and political relationships are underway, and possibly accelerating, given the U.S.'s current problems and their potential cures.

Market Review

During the fourth quarter, global equity markets declined significantly, as the continuing credit crisis and an accelerating recession caused a rapid flight to quality. U.S. markets declined roughly 25% during the quarter and declined nearly 40% for the year as shown in Exhibit 1. Small cap stocks fared even worse, declining by over 30% for the quarter, bringing annual declines to roughly 40% as well. During 2008, every sector except the more defensive consumer staples (-16%), declined by over 30%. There were simply few places to hide.

International equities performed nearly as poorly, declining 22% during the quarter, bringing 2008 losses to over 45%. Despite its strong performance during the flight-to-safety period in October and November, the U.S. dollar posted only modest gains for the quarter, detracting from non-U.S. equity returns by 2%. Emerging markets lost 29%,

Exhibit 1: Historical Performance



bringing 2008 declines to nearly 55%. Within this area, China declined 16%, bringing 2008 declines to a staggering 65%. Japanese equities were a relative bright spot, declining only 9% and were down roughly 30% for the year. However, most of the relative gains were due to increases in the Japanese yen, which surprisingly was stronger than the U.S. dollar.

Bond returns were once again widely divergent depending on credit quality. U.S. Treasury bonds increased 13% for the quarter, benefitting from the global flight to safety. High quality municipal bonds also improved slightly during the quarter. Conversely, high yield bonds continued their unprecedented slide, declining an additional 5% for the quarter, as high yield spreads widened to near record levels, from 854 b.p. to over 2,000 b.p. (20%) above treasury bonds.

Hedged strategies declined about 10% during the quarter and 20% for the year, marking the sector's worst performance ever. Many industry experts believe the actual performance in this sector was far worse, as many funds simply stopped reporting results, likely due to large losses and the possibility of closing entirely.

We do not have comparable data to include in Exhibit 1 for nonmarketable real estate or private equity markets. With very few transactions in these asset classes, we have only anecdotal information and believe that both areas continue to weaken and, in some cases, values are down significantly.

Overview

As we examine current economic and capital markets conditions, it is helpful to divide our discussion into near-term considerations and the long-term consequences of the current environment. The near-term issues are excruciatingly obvious, as the credit crisis continues to erode the global economy at an accelerating pace. Unfortunately, the solutions to the problem are not quite as obvious. The range of economic and market outcomes remains wide, mandating a cautious approach for risk conscious investors such as ourselves. The longer-term picture remains unclear, but we believe a reordering of global economic and political relationships is underway, and possibly accelerating, given the U.S.'s current problems and the potential cures.

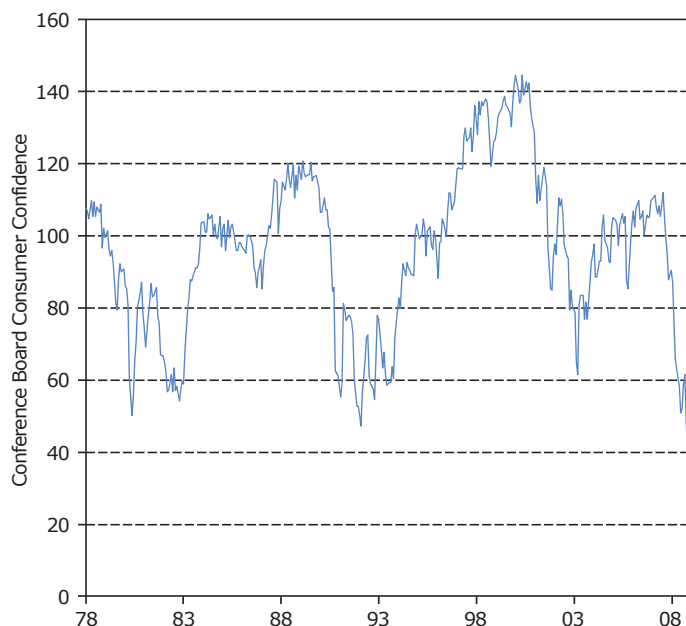
Credit Crisis and the Economy

It's official. The National Bureau of Economic Research has finally declared the U.S. economy to be in recession. While chapter one of the downturn revolved around the credit and banking sectors of the economy, chapter two is clearly centered on the consumer. Warren Buffett recently stated, "In my adult lifetime I don't think I've ever seen people as fearful, economically, as they are now." Consumer confidence readings clearly echo this statement, as indicators reached an all-time low during the fourth quarter (see Exhibit 2). This fear is beginning to impact consumer spending, which declined 3.8% in the third quarter, representing the largest drop in nearly 30 years. This is particularly troublesome since consumers account for roughly 70% of U.S. economic activity. Compounding the consumer spending decline is the rapidly accelerating unemployment rate; the U.S. economy lost 2.6 million jobs in 2008, with 75% of the job losses vanishing in the last four months of the year.

In the corporate sector, the severity of the challenge is just now becoming clear. Analysts believe corporate earnings will decline over 20% during the fourth quarter, marking their sixth consecutive quarterly decline. Further, most analysts believe the economic slowdown is still in its early stages. At a broader level, U.S. GDP contracted at a modest annual rate of less than 1% during the third quarter, but the decline accelerated to 3.8% during the fourth quarter. Hidden in the recent release is that GDP excluding inventory buildup (which is treated as a positive) contracted at a 5.1% annual pace, the worst in nearly 30 years.

The overall economic picture is rather gloomy and relief does not appear to be coming quickly. Market participants have embedded some of this bad news in current prices, particularly in the debt markets as we discuss later, but we are likely to have additional surprises going forward.

Exhibit 2: Consumer Confidence



Balance Sheet Recessions and Consumer Deleveraging

This recession is not the typical business cycle recession. Rather, we are experiencing a balance sheet recession fueled by the systemic deleveraging of consumer and banking balance sheets. While the deleveraging process in financial institutions is well underway, consumer excesses took years to build and will likely take years to unwind. Exhibit 3 (on the following page) shows that the buildup in private sector debt has tracked consumer spending quite closely. The increase in America's household spending since 1980 has been built on leverage or borrowing. In the past, government officials have been able to stimulate spending by simply making debt cheaper and more readily available. As we discuss later, reducing interest rates to make debt more affordable is no longer an effective option, as interest rates are approaching zero.

David Rosenberg of Merrill Lynch recently estimated the cumulative loss of household wealth for the past 18 months, based on declining equity values and home prices, was "probably north of \$13 trillion" or roughly 20% of private sector balance sheets. This is significantly larger than the household balance sheet declines during the tech bubble bursting (-9.6%) or mid-1970's (-3.6%). Rosenberg further estimates that this decline, when combined with growing unemployment, may create a \$1 trillion (roughly 7% of GDP) drag on GDP in 2009.

One analyst recently estimated that mortgage equity withdrawals counted for a shocking three percentage points

of annual GDP growth from 2002-2007. If accurate, this implies that mortgage equity withdrawals accounted for roughly 100% of real GDP growth over this period. The net result is that the consumer will certainly undergo a significant period of retrenchment as they increase savings rates and attempt to reduce their outstanding debt to reflect the ongoing declines in housing prices, a central component of most household balance sheets.

Balance sheet, disposable income and liquidity retractions will be significant. While the Federal Reserve is injecting liquidity rapidly, most analysts believe the federal government's ability to offset these declines in 2009 will be limited given their magnitude and the typical lags in implementing stimulus programs.

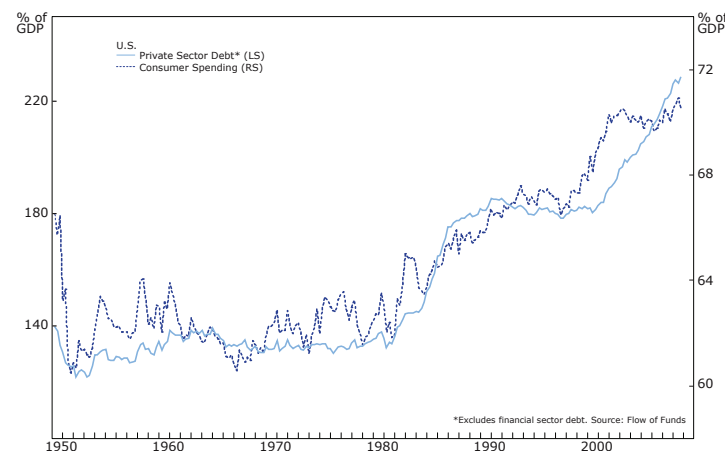
Historical Precedents

Mark Twain once said, "History doesn't repeat itself - at best it sometimes rhymes." While it is tempting to draw on past recessions to predict the path of our current circumstances, the reality is there have been only a handful of recessions over the last 80 years from which to draw parallels. Additionally, the current environment is not a typical business cycle recession, but rather the bursting of serious bubbles in the housing and credit markets for which even fewer precedents exist. Accordingly, we are wary of analysts willing to predict the length and severity of the downturn based on historical precedent.

Most analysts attempt to draw parallels to Japan in the 1990's or the U.S. in the 1930's. While we face serious adjustments, it seems likely that we are on a different path than either episode would suggest. One of the biggest problems during the Great Depression was the U.S.'s adherence to the gold standard, which forced monetary aggregates to contract severely at a time when authorities should have been expanding money supply and providing economic stimulus. (See Exhibit 4). The U.S. compounded this problem with significant protectionist measures that further curtailed global trade and economic activity.

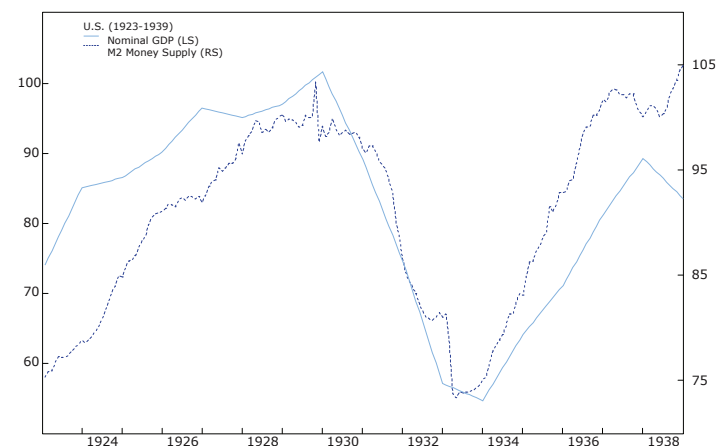
Similarly, Japan in the 1990's was slow to provide aggressive stimulus, restricting fiscal and monetary policy during the early years, failing to adequately address the problems in their banking system, and actually allowing the yen to rise during the early half of the decade (a growth dampener in an export driven economy). As a result, in both cases, economic downturns were prolonged.

Exhibit 3: U.S. Consumer Debt and Spending



Source: © BCA Research 2009

Exhibit 4: Depression Era Money Supply and GDP



Source: © BCA Research 2009

U.S. Fed Policy and Government Stimulus

Conversely, the U.S. Federal Reserve is aggressively stimulating the economy by dropping interest rates to nearly zero and increasing the available supply of money. Equally as important, Federal Reserve Chairman Ben Bernanke pledged to use "all available tools" to contain the financial crisis. With no room to lower interest rates further, the Federal Reserve has expanded its balance sheet at the fastest pace on record, more than doubling its size in the last few months of the year (see Exhibit 5, first panel) to purchase distressed assets and provide various guarantees. Potentially more troubling than the increasing size of the Fed's balance sheet is the associated decline in asset quality. The Federal Reserve's balance sheet, historically comprised of nearly all high-quality Treasury bonds, is now dominated by lower quality assets purchased over the last few months.

Not only are the Federal Reserve's money spigots turned on, the fiscal floodgates are wide open. President Obama has already called for the release of the remaining TARP funds and is building support for an \$825 billion (at last count) tax-cut and spending plan. It appears there is no limit to what the government is willing to spend to stave off a collapse of credit markets and the economy.

Is the Bailout Working?

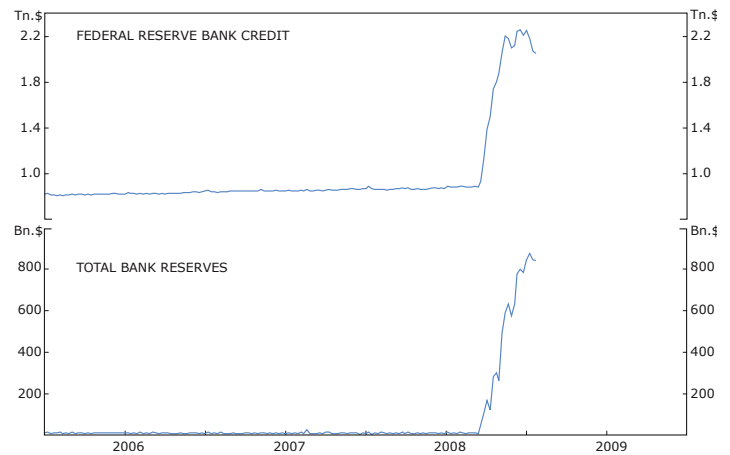
All this leads us to a key question: is the bailout working? As we have stated in prior Market Reviews, we should not view a banking crisis in the same manner as a typical recession. Credit is the lifeblood of the economy and the banking system must be functioning before a broad economic recovery can begin. While recognizing the "moral hazard" risks associated with bailouts and interventions, the U.S. government has demonstrated an unprecedented commitment to supporting the banking system and thawing the credit freeze currently gripping the U.S. economy. However, the question of whether the bailout will be enough to restart the economy remains unanswered and is the primary risk we face over the intermediate term.

On the positive side, it appears as if the capital market panic of October and November has retreated, at least temporarily. One indicator of the market's retraction to more normal conditions can be seen in the VIX, sometimes known as the Fear Index, which indicates that implied future volatility of U.S. stocks has retreated from its near all-time high in November to around 40 today (See Exhibit 6).

Unfortunately, uncertainty remains and we expect elevated volatility levels to continue as we work through the credit crisis and the unfolding economic recession. Similarly, in the banking sector, we see small signs of improvement, but we still have a long way to go before lending conditions return to normal. Unfortunately, the liquidity provided to the financial system is only slowly making its way into the broader economy. Additionally, the government has not yet enacted stimulus programs aimed at the consumer, as most efforts to date have targeted stabilizing the banking system. Several factors are contributing to the limited effectiveness of programs:

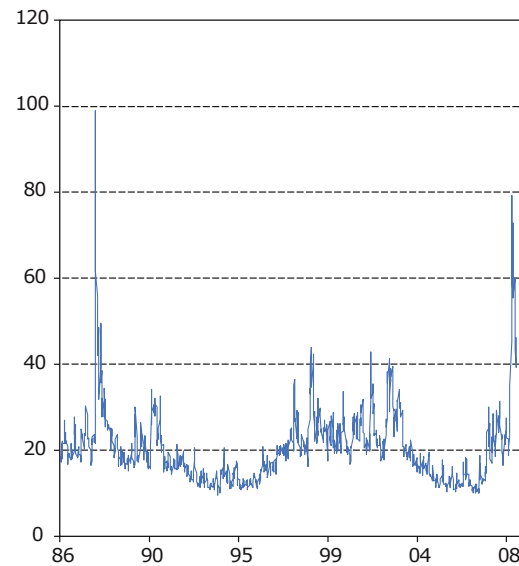
- Banks are hoarding money to heal their balance sheets rather than resuming lending activity. Many analysts believe this may continue for some time, as banks' demand for capital to offset ongoing write-offs remains high (see Exhibit 5, second panel).
- Banks will not resume lending until the value of collateral used to secure loans stabilizes. For mortgages, this means the housing market supply and demand must come back into balance and housing prices stabilize.

Exhibit 5: Expanding the Federal Reserve Balance Sheet and Bank Reserves



Source: © BCA Research 2009

Exhibit 6: The VIX: Equity Market Volatility



Source: Bloomberg

- Consumer demand for loans is actually declining as their balance sheets contract. For the first time since 1952, consumers reduced their outstanding debt.
- Most analysts believe that relief for the consumer likely in the form of housing stabilization programs, will initially be saved by consumers to restore their balance sheets rather than stimulating demand. While the federal government and the Federal Reserve have responded quickly and acted aggressively, it is clear that more work is required and significant risks to the ultimate success of these programs still exist, including:

- The current crises may simply be beyond the capacity of the G-7 central banks to resolve, which could lead to a potential meltdown of the financial system and a more severe, prolonged economic contraction.
- It may take years or even decades to restore investors' confidence in the financial system, government and corporate leadership, and regulatory institutions.
- Protectionist rhetoric has been escalating, as the cry to protect "our" businesses grows louder in countries around the world. Protectionist policies are usually met with escalating retaliatory responses, which tend to slow global trade and retard economic growth. Recent examples include the "buy America" language in the proposed stimulus package and the renewal of calls by steel executives to protect the domestic steel industry.

Our Approach Revisited

Clients continue to ask us the question: "Will the financial system melt down or is this simply a market correction that ranks among the largest in history?" While we believe the risk of a financial system collapse has diminished, the range of possible outcomes is still very wide and the truth is that no one knows where this crisis will lead us.

As we discussed in recent Market Reviews, we do not believe that investing for a financial meltdown is a viable strategy. It is impossible to assign a high enough probability to a meltdown to justify acting on it. The investments you would consider if convinced of a pending meltdown would be a disaster in the higher probability event that markets return to some level of functionality. Additionally, such an investment solution may not provide the protection investors seek, as unknown risks can undermine even the safest strategies during crisis periods. Witness the auction rate securities market and money market fund problems in 2008.

Risk management is a continuous endeavor for us, not a part-time exercise predicated on our ability to foresee a crisis and time our investment actions to prevent a drawdown. Our focus is on trying to understand the nature of risk and avoiding areas that present an increased chance of outsized drawdowns and permanent loss of capital, even if it means giving up some potential reward. This difficult period has reaffirmed many of our investment principles, including several that are particularly relevant in order to accomplish this objective:

- *Find Managers who Share our Risk Conscious Approach:* It is important that these managers are fundamental in their approach, believing when they buy an asset that they are paying a fair price in absolute terms. One of the

most important idiosyncratic risks for any asset is price. Good assets purchased well typically do not lose money over time, although they may temporarily decline from the value at which you purchase them. In addition, we prefer that our managers have a broad mandate, which allows them to rotate toward more attractively priced areas of opportunity, possibly even cash, to lessen losses or possibly achieve higher returns.

- *Opportunistically Find Attractive Investment Areas:* Based on our view of the world, which is significantly influenced by many of our managers' bottoms-up ideas, we seek areas of investment that may benefit from, or mute, the effects of any major downturn. While the flexible mandates of most of our managers allows them to rotate into opportunities, occasionally, we will want to augment an existing exposure or add an exposure that is outside the scope of our current manager set. Our partnerships' structures facilitate this opportunistic approach in shifting client capital to these areas. Our short sub-prime debt investment and current rotation into distressed debt are examples of this opportunistic approach. We describe our current areas of interest below.

- *Keep an Open Mind:* For lack of a more elegant way to describe this principle, the frameworks of the past are useful only to a limited extent. One must continually test to ensure past relationships will endure and be mindful of intellectual laziness that allows for false conclusions from outdated constructs. A rigid approach prevents the appreciation of events that make historical practices unlikely to succeed in the future. Many of our longer-term themes and concerns described below are based on changing paradigms, highlighting the risk of rote extrapolation.

Current Opportunities

The bright side of the current malaise is opportunity. Capital market participants are beginning to embed their negative news into asset pricing in certain areas. A world short of debt and equity capital tends to be a point from which investors have realized unusually good returns in the past. The debt markets appear to have reached this stage. The massive fourth-quarter declines in equity markets appeared to have moved these markets closer to fair value as well. While valuations may be more attractive, risk levels are elevated throughout the capital markets and further market declines are certainly possible. We are focusing on several places within the capital markets that we believe provide attractive risk/reward opportunities:

- *Distressed Debt:* Many holders of debt securities have become distressed sellers, driving yield spreads on both

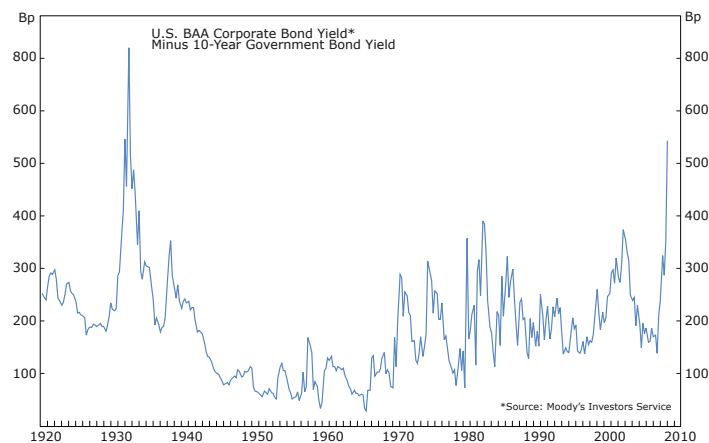
low quality and higher quality debt to near historic levels (See Exhibit 7). If the economy weakens significantly as expected, we should have a “gold standard” opportunity in distressed debt. In preparation for this, for over a year, we have been building our stable of distressed debt managers. We feel our specialist managers in this area have greater transparency and hard catalysts, such as coupon payments, sinking funds and maturity dates, which provide a firmer foundation for valuation and risk assessment. Accordingly, we are allocating assets otherwise earmarked for equity strategies to the distressed debt arena. As of January 1, within our domestic equity partnership, Gresham Select Asset Managers, we had allocated roughly 30% of capital to dedicated distressed debt managers.

- **Bank Stocks:** Valuations for banks have been devastated given the distress in financial institutions, and the tendency of investors to paint every bank with the same negative brush in a panic. While we expect to see continuing negative news on banks, including an increasing number of bank failures, we believe a manager with a specialist’s expertise can identify and purchase “survivor” banks at very attractive prices. We have initiated a slow and disciplined process with a specialist manager to buy regional and community banks around the U.S.
- **International Equity:** Our clients will recognize that we have emphasized international equity over domestic equity for a number of years. Despite the fact that the current credit crisis is focused here in the U.S., foreign stock markets have fallen by a greater amount and currently sell for valuations well below that of U.S. markets. Additionally, our interest in China and Japan remains strong.
- **Municipal Bonds:** The primary fixed income investment for most of our clients now yields more than taxable treasury bonds. While we think inflation will eventually become a larger concern, current yields seem high enough to offset this risk. As a result, we have reduced our long-standing underweight to municipal bonds and high quality fixed income generally.

Current Partnership Exposure and Protecting Principal

With the combination of our focus on risk conscious managers and our opportunistic allocations to non-traditional strategies such as distressed debt, the market exposure of our equity partnerships is relatively low. Several of our long-only equity and distressed debt managers maintain large cash balances to protect capital and wait for even bet-

Exhibit 7: Corporate Credit Spreads



Source: © BCA Research

ter pricing. Additionally, many of our long-short equity managers maintain low or even net negative market exposure. We believe that our partnerships, as currently positioned, will continue to perform relatively well if markets decline further, providing clients with a measure of protection.

A Note on Manager Due Diligence

Of all the losses in the market over the last year, loss of trust may be the largest. In recent weeks, several clients have asked what steps we have taken to minimize the risk that Gresham clients become victims of fraud such as the Madoff Ponzi scheme. We believe a significant contributor to this type of problem is what one commentator recently referred to as “dumb money and dull diligence.” In an effort to create scalable business models, many consultants rely on checklists and backwardlooking statistical analysis, which can be used by armies of junior analysts, in lieu of a real understanding of the investment strategy and the person running it. Risk is a complex, often-difficult concept to understand that does not easily distill to nice statistical measures and checklists. We believe there is no substitute for experienced judgment and persistent, often unconventional, exploration in an effort to understand the risks we take on behalf of our clients.

As our clients know, we were encouraged numerous times to “investigate” (i.e. invest with) Mr. Madoff. Despite meeting with him, we simply could not understand how his stated strategy could produce the results and consistency he claimed. While Mr. Madoff probably passed the checklist test and certainly aced the statistical analysis test, we simply couldn’t form a clear picture of how he accomplished

his results. While we do look at auditors, administrators and perform rigorous performance analysis, we feel it is more important to understand the people and the implementation of their strategy than simply checking the boxes. Our approach isn't perfect and we may occasionally miss good investment opportunities, but we believe our patient approach, which emphasizes finding great people and understanding risk first, has served our clients well for a long time.

Long Term Themes and Concerns

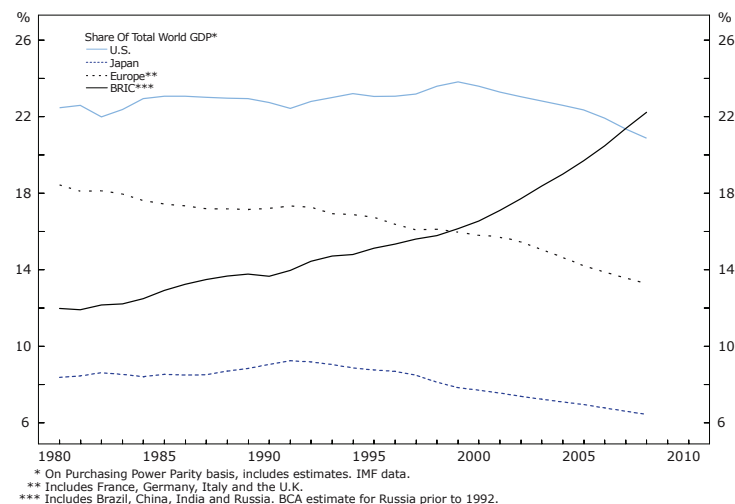
While we remain concerned about current conditions, the time to think about the problems we face now was 1-2 years ago, and we did. The returns earned by our clients on shorts of subprime debt and the ability of our managers to limit losses in difficult markets are evidence of this. It is important for us to continue to look forward, considering the changing landscape and the opportunities and risks it presents.

Realignment of the Global Landscape

As we discussed in some detail in our last Market Review, we are at the beginning of a seismic shift in the historical world order of economic, political and military power, which several analysts and investors, including Mohammed El-Erian in his recent book, have discussed. In order to invest productively over coming years it will be necessary to understand both the ultimate destination and the opportunities and pitfalls that may lie along the way:

- We are in the midst of a fundamental realignment of global economic influence, including a gradual handoff to a set of developing countries that previously had little systemic influence.
- A pronounced, continued accumulation of financial wealth by these countries that includes some more accustomed to being debtors than creditors. The continued growth of these financial resources, including sovereign wealth funds, and their natural desire to diversify capital more broadly will lead to a shift away from their current U.S.-centric fixed income investments toward higher risk assets across a broader array of countries, asset classes and currencies.
- The engine of worldwide economic growth will be less dependent on the U.S. consumer. Instead, emerging markets will constitute an increasingly independent driver of growth, as they further evolve their economies

Exhibit 8: BRIC Economies Continue to Grow



Source: © BCA Research 2009

from export-oriented businesses toward higher domestic consumption. This trend is well underway and should accelerate in the coming years (See Exhibit 8).

- A U.S. economy that has long been overly dependent on debt-financed consumption will need to make the much needed and long delayed adjustment to create better global economic balance and reduce its financial vulnerability. Some estimate that the U.S.'s financing needs could exceed \$2 trillion in each of 2009 and 2010, possibly absorbing more than 100% of global savings.
- A disinflationary tailwind of the last decade, which was caused by the introduction of over one billion workers from emerging markets into the global economy, will shift to an inflationary headwind as emerging economies continue pursuing rapid growth and become increasingly large consumers of commodities and other resources of all types.

These shifts amount to a "game changer" in the world order. Developed nations will find it difficult to acclimate to the new circumstances, which will require them to share the global pie more broadly. Global policy solutions will require broader participation among nations and stronger leadership. Witness the recent failed Doha round of trade discussions or the November meeting of the world's economic leaders to discuss solutions to the current crises, which notably included the G-20, rather than the traditional G-7.

The current economic and credit crisis centered in the developed markets is accelerating these changes. The U.S. – China relationship is at the core of this realignment, but the influences and impacts will be felt by nearly every

nation. Over the last 20 years, the global economy was built on the tightly integrated, but enormously lopsided twin pillars of U.S. over-consumption and negative savings that were financed by China's production and excess savings. As evidence of the growth of this imbalance, the U.S. trade deficit with China has grown eight-fold over this period and China is on the verge of overtaking Canada as America's largest trading partner (see Exhibit 9). As we discussed earlier, with the U.S. consumer at the beginning of a long deleveraging phase and increasing savings rates, it is clear this relationship is about to change dramatically. In a broader context, these changes will likely accelerate the global structural shifts already underway.

This will be a long and tumultuous journey. We can look for geopolitical events to be much more important. Among the greatest risks during the transition are:

- **Interventionism:** The pendulum is clearly swinging from the Ronald Reagan/Margaret Thatcher era of laissez-faire economics toward what one analyst called a "New Era of Interventionism". Additionally, many of these new global entrants practice a form of state capitalism in which political and economic goals are mixed.
- **Protectionism:** The related risk of global protectionism is rising, as constituents will lobby to protect industries that are facing failure due to the combined effects of a global slowdown and increasing global competition. Recent calls for protections and bailouts in the U.S. auto and steel industries are likely to be only the beginning. These actions can escalate to trade wars, particularly when the world's leadership is weak or in transition.

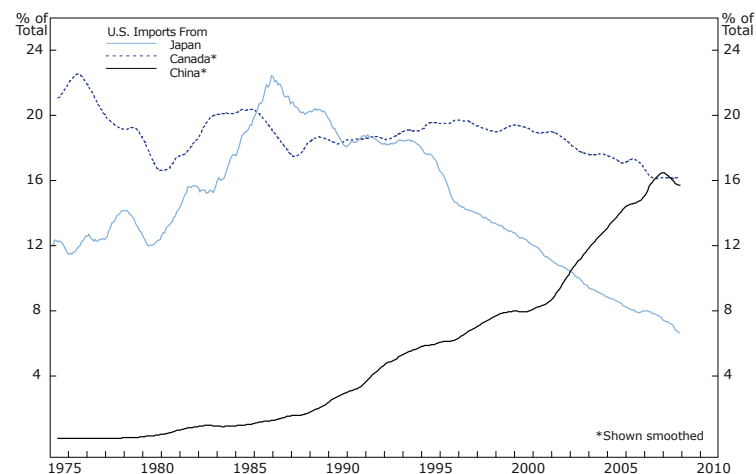
These risks tend to lead to unpredictable and sometimes unintended outcomes that will keep volatility and risk levels elevated for some time.

Inflation

Over the last few decades, the world has benefitted from the opening of global labor markets, which despite one of the longest periods of synchronized global growth in history, led to structural disinflation. If this recession lasts as long as some analysts now predict, it is highly likely that excess capacity and slack in various parts of the economy will develop, reducing the possibility of near-term inflation.

While the world will continue to benefit from these labor cost differentials, the shrinking wage gap and increased protectionism will surely provide reduced benefits in the future. Many emerging country governments are more focused on economic growth than controlling inflation, as

Exhibit 9: China's Trade with the U.S.



Source: © BCA Research 2009

their primary goal is to lift their populations out of poverty. Additionally, when economic trends turn up, it will be difficult to reverse the massive fiscal and monetary measures taken to offset the current crisis. At best, it is difficult to calibrate policy efforts under stable conditions. It will be even more difficult to withdraw liquidity in the correct amounts at the correct time to avoid overshooting the target. If history is any guide, it is likely the Fed will err on the side of caution far too long. Unfortunately, government programs, once started, are notoriously difficult to shrink or eliminate.

With too much money circulating in the system, the focus will eventually shift back to inflation. One key question that remains is whether this excess liquidity translates to real goods and services inflation (i.e. CPI inflation) or simply reverts to its bad habits from earlier this decade and creates a series of asset bubbles.

The U.S. Dollar

The U.S. begins this journey with a relatively healthy balance sheet, as direct obligations of the U.S. Treasury are below 50% of GDP. However, rapidly growing indirect obligations combined with the U.S.'s need to issue over \$2 trillion in debt in 2009, may put pressure on the government's ability to finance these obligations. We agree with the analysts who believe the U.S. government will not face a financing crisis. However, selling dollar-denominated debt is equivalent to selling dollars and we are growing concerned that the combination of financing large U.S. deficits and the Federal Reserve increasing the monetary base poses a serious threat to the long-term strength of the U.S. dollar.

In the near-term, investors' flight to safety and their need to pay down debt denominated in dollars will likely inflate demand for the U.S. dollar. However, in the longer-term, the question is more likely to be how far and how fast the dollar needs to fall to find equilibrium in the new world order we foresee:

- We continue to hear popular theories about the possibility of a run on the dollar driven by foreign investors, particularly the Japanese and Chinese governments, who are the largest holders of U.S. Treasury obligations. We agree with analysts who believe this is unlikely, as such a run would devalue the largest component of these countries' financial reserves and destroy U.S. import demand, upon which these two economies are highly reliant.
- An orderly decline of the U.S. dollar could be a positive outcome, as it tends to encourage manufacturing activity in the U.S. and help to rebalance the economy away from the excess consumer spending that has characterized the last few decades.
- Unfortunately, a declining currency also tends to be inflationary for import-dependent economies such as the U.S. In the simplest terms, imported goods, as measured in dollars, would be more expensive. Given our desire to protect the global purchasing of client assets, this adds to our aforementioned concerns regarding inflation.

Implications and Our Approach

These concerns and questions create the need to look ahead and explore methods of protecting capital and exploiting opportunities:

- As consumers in the emerging economies adopt developed nation consumption habits, the world will have an increased demand for infrastructure and resources of many types, including commodities. Our primary concern with investing in this area is the predominance of momentum-driven and speculative strategies that create bubbles and large drawdowns for investors. One positive is that the current entry point is much more attractive after the commodity collapse during the second half of 2008.
- An age of interventionism and protectionism will lead to unexpected events, creating higher risk levels. Additionally, increasing economic power in the hands of governments practicing state capitalism and those who have shown that they are willing to change the rules of investing will only increase market volatility.

- International markets will continue to offer more favorable business opportunities, especially in some of the better-governed emerging markets. The scale of potential growth and investment opportunities in these countries is enormous. The consumer population is already large and growing rapidly. Goldman Sachs recently estimated that the world will generate two billion new middleclass consumers by 2030 and a large number of them will be in countries like China and India. Whole industries are largely missing and need to be built. Existing companies in these countries will grow their share of world markets as they improve operational efficiency and climb the value-added curve, developing global brands of their own. The opportunity is especially attractive in private equity, as a higher proportion of companies in these countries tend to be privately held as their capital markets are still developing.
- Our concerns about the devaluation of the U.S. dollar are particularly acute for our U.S. based clients, whose assets are predominantly dollar denominated. In the interest of preserving global purchasing power, we are more aggressively exploring ways to: 1) reduce residual dollar exposure within the Gresham Foreign Managers partnerships, 2) employ an active currency overlay that might benefit from the increased currency volatility associated with the changing global landscape, and 3) develop an effective method of explicitly incorporating a short dollar exposure within client portfolios. However, currency markets are the ultimate zero sum game, and are often driven by factors other than fundamentals. Therefore, we approach this question with caution.

Domestic Equities

U.S. stocks declined roughly 25% in the last quarter and were down nearly 40% for 2008. With the recent trend toward normalization of market stress indicators that we mentioned earlier, we may have passed an acute phase of financial system peril and the market may begin to resume what will likely be a fitful digestion of fundamental information, much of which may not be positive in the near-term.

It is worth noting that the October S&P 500 decline was one of the sharpest and most severe declines in market history. A rally at the end of the month lifted the S&P 500 from its intra-month low of down 27% to a decline of "only" 17%, which still ranks as the second largest monthly decline since 1945.

Corporate Earnings Outlook

Current earnings forecasts are subject to massive revisions, rendering them nearly useless:

- Earnings forecasts continue to decline at a remarkable pace that makes us wonder if anybody is paying attention. The estimated earnings growth rate for the S&P 500 in the fourth quarter of 2008 is now -20%. On October 1, the estimated growth rate was a POSITIVE 46% and as recently as January 1, the estimated growth rate was -1%.
- Even if we remove financials, whose earnings analysts expect to decline 98% from an already depressed level, the remaining nine sectors of the economy would still be expected to decline over 17% in the fourth quarter.
- Forward earnings estimates appear greatly exaggerated and are likely subject to similar downward revisions. Analysts currently expect earnings during the first two quarters of 2009 to decline by 15% and 14% respectively. Additionally, current forecasts call for fourth quarter 2009 earnings to rise nearly 40%, but we believe these estimates are likely subject to significant downward revision.

Valuation

Valuation remains difficult to assess as we remain in a race between declining corporate profit expectations and declining share prices. Based on these highly suspect current and forward earnings estimates, the S&P 500 is estimated to be trading between 11x and 12x earnings.

- On a positive note, this is modestly below long-term valuation averages for the equity market. During difficult periods, priceearnings ratios have typically been higher as the market tends to discount trough earnings with some expectation of a rebound. In the ten market corrections since 1962, most trough multiples have been in the 10x – 15x range. On the other hand, the 1974 and 1982 trough multiples declined to roughly 8x.
- If forward earnings estimates decline significantly, as seems likely, the “real” current price-earnings multiple may be higher than currently assumed.

While it is difficult to develop conviction given the uncertainty of forward earnings estimates, valuations are more attractive than those we encountered in 2007 and early 2008. However, we feel that many of our managers have better transparency into the cash flows and valuations in the debt markets and these markets have more aggressive-

ly accounted for negative economic and business trends. Accordingly, we have been shifting equity allocations to the distressed debt markets.

International Equities

Foreign stocks declined 22% during the fourth quarter and were down roughly 45% for 2008. The dollar’s appreciation reduced returns to U.S. investors by a modest two percentage points in the quarter and four percentage points for the year. Japan enjoyed slightly better results, declining 30% for the year, primarily due to appreciation of the yen. Emerging markets lost 29%, bring 2008 declines to nearly 55%. Within this area, Chinese stocks declined over 65% in local currency terms, but RMB appreciation limited losses to 51% for a U.S. investor.

Opportunities and Relative Valuation

Our continuing preference for foreign stocks over U.S. stocks rests on several factors. In the simplest of terms, the opportunity set is larger and growing more rapidly. In general, the long-term trend toward a new world order we described earlier should favor international over domestic investment. While risks to investors are generally higher outside the U.S., and in some cases much higher, it is our belief that very experienced and risk conscious managers can navigate such risks for the benefit of investors.

- In general, we favor international markets over U.S. markets due to better valuations, despite earnings uncertainty in both markets. At year-end, it appears that the S&P 500 is trading at over 11x forward earnings while other developed markets trade at 9.8x and emerging markets at 8.6x.
- More specifically, we continue to be attracted to the higher growth rates in Asian economies, particularly China. While these economies will not be immune to the global economic slowdown, many will not experience the degree of banking system trauma or the deleterious effects of consumer deleveraging that will be required in the U.S. and other developed nations.
- Additionally, many developed countries, such as Japan, present the opportunity to capture the benefits of an extended process of corporate restructuring, rationalization, and political change.

Japan

From a valuation standpoint, Japan is the most attractive market in the developed world. While the economic headlines will continue to be negative, we are attracted to investments in Japan for the following reasons:

- Exhibit 10 shows that, based on price/ book ratio, Japanese stocks are trading at their cheapest levels in over fifteen years. Nearly 80% of companies in the TOPIX Index trade below book value, compared to less than 50% for developed Europe and only 30% for the U.S.
- Corporate management appears to be more responsive to shareholder concerns. Share buybacks and management buyouts are accelerating. Activist investor efforts have gained more traction as they refine their tactics to fit Japan’s cultural norms.
- The Japanese pension authority voted against reseating directors at over 60 companies who failed to meet their targeted 8% ROE hurdles. Additionally, the Japanese government is actively contemplating tax reform that would make foreign investment more attractive.
- Excess cash balances, once viewed as a trapped asset on corporate balance sheets, provide Japanese companies the ability to withstand the current credit crises and provide a war chest for acquisitions at today’s more attractive valuations.

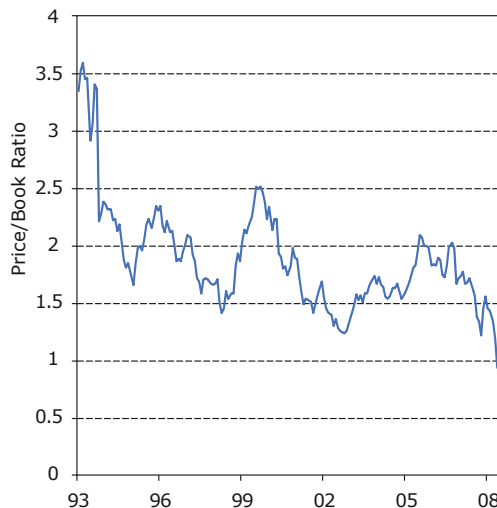
China

We agree with those who believe that the industrialization of China and the emergence of its consumer class will rank as the world’s foremost economic change over the next few decades. This transformation is underway and the scale of the future opportunity is impressive. As China becomes less reliant on exports and their rapidly expanding consumer class increasingly fuels growth, it will become a more stable economy.

While China has a closed political system, it has one of the more entrepreneurial economies with an increasingly vibrant society. At this point, these opportunities still involve high risks and can often be illiquid. However, we believe the potential for higher growth and profitability justifies the risks of long-term investments.

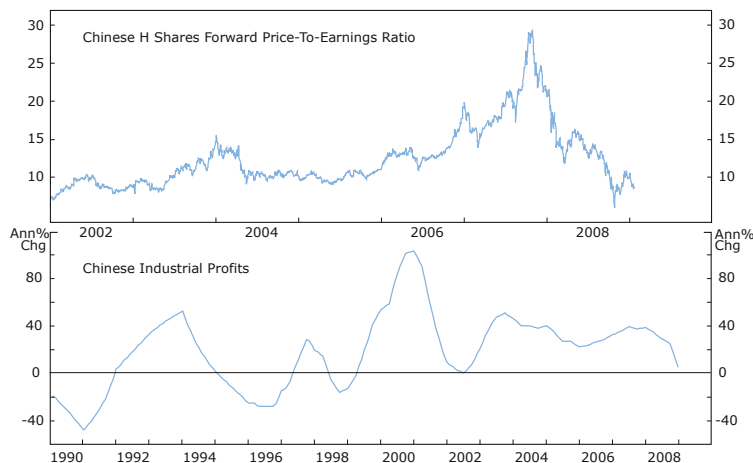
In addition to the long-term opportunity, we now feel valuations are becoming more attractive. The Chinese stock market has recently been one of the worst performing markets in the world, while earnings growth projections have declined only modestly (see Exhibit 11). As we entered the

Exhibit 10: Japanese Equity Valuation



Source: Bloomberg

Exhibit 11: Chinese Equity Valuation and Business Profits



Source: © BCA Research 2009

Chinese market several years ago, our primary concerns centered on valuation and finding managers in whom we could gain some measure of confidence. We made progress in both of these areas and expect to build our allocations over time. However, we still see a number of risks that suggest we proceed with caution:

- Earnings visibility is still limited given the improving, but somewhat lesser, accounting practices and management expertise. Investors should require higher premiums for investing under these conditions.
- Protectionist rhetoric will likely target China as one of the U.S.’s largest trading partners and a source of low-cost manufacturing. These measures could have dramatic and unforeseeable effects on valuations and volatility.

- The government of China is wrestling with a number of complex and conflicting issues related to its primary objective of continuing rapid growth. It is possible that the Chinese government will simply erase many of their recent economic and market reforms in an effort to regain control should things go awry.

Bond Markets

U.S. Treasuries were the big winner in 2008. Intermediate treasury bonds returned 13% in the fourth quarter and nearly 19% for the year. Given the skepticism with which investors view corporate credit, it is not surprising that high-quality corporate bonds declined for the year. Municipal bonds provided modest protection and were roughly flat for the year.

Lower rated, higher-yielding segments of bond markets are still searching for a bottom. U.S. high-yield bonds declined an additional 5%, bringing 2008 losses to 19%, as high yield spreads widened dramatically. At the end of the year, high yield spreads had widened to over 2000 basis points (20%) from 850 basis points one quarter earlier (see Exhibit 7 on page 8). Moody's is currently forecasting a rise in the default rate in CCC rated bonds from the current 3% to 7% over the next year. Most analysts believe that corporate bond default rates will be higher and market prices for debt instruments are implying a default rate more than double that.

Municipal Bonds

Municipal bonds have become more attractive as well. With the decline in municipal bond values, their yields now significantly exceed those of comparable treasuries, despite their tax-free status. These yields may be partially due to investor perception of increasing credit risk as state and local budgets face massive deficits and potential defaults. Additionally, we have seen a seismic structural shift in the municipal bond market, as municipal bond insurance, which once accounted for over 50% of outstanding issuance, has been relegated to a secondary consideration as insurers were discredited and downgraded. This has forced municipal hedge funds and other non-traditional buyers of municipal bonds to exit the market and created a temporary imbalance in supply and demand.

As we consider investing in the area, the absolute level of municipal yields appears to provide some degree of insulation against our longer-term inflation fears and could provide appreciation potential in the short run if we enter a deflationary period as the global economy slows. This recently presented an opportunity to recommend partially

reversing our substantial underweight in fixed income that we initiated in 2003 when treasury yields hit, what at the time was, a 40 year low.

Hedged Strategies

Hedged strategies were down about 10% in the fourth quarter and nearly 20% for the year. While these results are far better than equity markets, they represent the worst performance ever recorded for hedged strategies. Additionally, some of the largest and most highly regarded players in the field suffered even worse results and are down 35% or more.

Hedged strategies managers are suffering from several issues, some of which typically occur in an environment like the current one and some which are new.

- Massive redemptions from hedge funds created panic selling in securities and trades that were crowded with hedge funds, exacerbating losses in a self-reinforcing cycle that caused further hedge fund selling. This is a symptom of too much money invested in the area.
- Leverage is now less available to hedge funds. Banks retracted existing leverage from managers, creating additional selling pressure as many funds were forced to unwind. It is unlikely banks will soon, if ever, return to offer leverage at the levels we witnessed in 2007 and early 2008.
- Government actions to suspend short selling in September in a large number of public companies illustrated our earlier stated concern regarding the greater role governments may play in markets. This caused large losses in (and the near elimination of) strategies such as convertible arbitrage and statistical arbitrage.

Longer Term Considerations

Investors are increasingly dissatisfied with hedged strategies and hedge funds more generally. Compounding historically poor performance is the revelation that many funds-of-funds, despite their claims of superior due diligence, were caught with Madoff exposure. While lockup periods, gating provisions and other restrictions on hedge fund withdrawals may retard a swift exodus, we believe the industry may continue to experience outflows as investors are no longer willing to believe in "dull diligence." It is expected that an unusually large number of hedge funds and funds-of-funds will close shop, while others will suffer reductions in assets, leading to the potential for further downward pressure on prices of securities owned by these funds. Indeed, the exo-

dus may have already begun, as hedge fund-of-fund assets declined last year for the first time since 1996.

We may not know for sometime whether this represents a secular change in the industry that may restore some of the attractive risk/reward characteristics or simply a cyclical hiatus. However, several factors give us reason to believe that the hedged strategies area may be more attractive for at least a while:

- History has shown that periods of poor performance in hedged strategies have usually been followed by periods of above normal returns, as spread relationships in arbitrage-type trades tend to revert to more normal levels.
- The elimination of the proprietary trading desks of defunct investment banks and the tighter controls of surviving firms will likely improve pricing and reduce competition for these ideas. Proprietary trading desks in aggregate were larger than hedge funds themselves, so this is a big change. One analyst recently estimated that the elimination of bank prop desks and reduced leverage in hedge funds and the surviving prop desks would remove nearly \$70 trillion in trading capital.

We remain concerned that returns in this category are now systematically more correlated to other major asset classes, reducing the diversification benefit provided to investors in this category. We will monitor developments closely to determine if the opportunities are fleeting or if the current pricing restores the risk/reward balance that made this category a core portfolio building block for investors.

Real Estate

Unfortunately, the real estate indices we often quote are now useless. The NCREIF property index is particularly unhelpful given its backward looking appraisal-based methods, which incorporate new trends slowly. Currently, it is clear that real estate pricing is down, which is not reflected in such indices. Even transaction-based indexes, which more quickly reflect price changes, are unreliable as transaction volume is currently at the lowest level in more than 15 years. As a result, we believe our conversations with real estate professionals are a better guide to recent developments.

Real estate operating fundamentals, always a lagging indicator given the long-term nature of leases, appear to be softening. Anecdotally, weakness is most apparent in the hotel sector, where "leases" rollover daily, and the retail sector, which is first to feel the contraction of consumer

spending. One analyst recently estimated that commercial office space rents in NYC could decline by 20% or more. Additionally, office vacancy is beginning to increase at modest rates, but these small increases mask the empty space that is available for sub-lease.

We are concerned that commercial real estate valuations have declined, in some cases, significantly. Cap rates, depending on property type, have likely increased as much as two percentage points, supporting the idea that valuations have declined over the last few quarters. However, it may be a while before valuations reflect these declines as many recent transactions involved significant leverage, whose terms were quite lenient and will not require refinancing for a number of years.

On the positive side, most real estate analysts view supply and demand, other than in the single-family housing sector, to have been in reasonably good balance in most property sectors going into the downturn, which could help to lessen the decline and shorten the time to stabilization and recovery.

Longer-term Trends

While real estate continues to gain credibility as a mainstream asset class, many investors likely underestimated the impact of leverage on returns and the illiquidity associated with the asset class. Accordingly, we expect to see the trend toward institutionalization continue, albeit with a near-term reversal or slowdown. We continue to believe that the international real estate markets, with less efficient pricing and a shortage of high-quality independent property management firms, present great investment opportunities, although at greater risk. One benefit of overseas investing is that leverage, while used in some transactions, was less prevalent, particularly outside of more developed countries.

In general, we like our position in commercial real estate. The frothy markets of recent years resulted in well below target investment levels for our clients due to a high rate of sale and a reluctance to chase rising prices by our managers. As a result, we have large committed, but unfunded, amounts outstanding in the hands of very accomplished managers in an environment where pricing is becoming significantly more attractive for purchases. The most attractive opportunities, currently, are in land, distressed debt secured by real estate, and busted or problem projects, often developments.

Private Equity

Similar to real estate pricing, the appraisal-based data from private equity is largely useless now. Market participants are completing few transactions. Prices have undoubtedly declined, but without transaction activity, valuations are difficult to determine.

Secondary market pricing is exacerbating the perception of valuation declines as many market participants rush to liquefy portions of their portfolio to remain in balance after suffering significant losses in the liquid portions of their portfolio. Anecdotally, discounts on sales in the secondary market for buyout funds of recent vintage years have exceeded 50% off of appraised value and, in general, pricing is down 30%-40% since the beginning of the year. The discounts may be overstated as they likely anticipate some year-end markdowns. We believe opportunities are very attractive for our investments in secondary market funds in our most recent private equity partnership. As an aside, it appears that the secondary market in real estate partnerships have become a larger portion of the market during this cycle for the first time.

After a record setting fundraising pace during the first three quarters of 2008, investor interest has declined significantly:

- Fund raising has cooled for large buyout funds. However, the existing pools of capital and funds raised prior to the third quarter provide an ample war chest for many of these firms.
- Venture capital funding remains in balance with deal flow. However, we remain concerned that the time to exit for many of these deals is longer, given the higher cost of operating as a public company, and the fact that the IPO market is still significantly constrained.

Our interest in overseas private equity remains high. Many of the most successful companies in developing countries are still privately held, as public market development still lags that of developed market countries. Additionally, these markets still operate with fewer experienced teams and large inefficiencies, generally creating better buying opportunities for our managers.

Summary

The credit crisis continues to erode the global economy at an accelerating pace. Governmental authorities are responding aggressively in an effort to thaw credit markets and avoid a severe and prolonged recession. While we are seeing signs of the banking system stabilizing and market volatility subsiding, we still face the question of whether these efforts will ultimately succeed. The range of possible economic and market outcomes remains wide, mandating a cautious approach for risk conscious investors.

The U.S. economy is now officially in recession. While chapter one of the downturn revolved around the credit and banking sectors of the economy, chapter two is clearly centered on the consumer. Consumer confidence and spending appears to be in the early stages of a secular decline. Over the last 20 years, consumer spending increases came largely from increased borrowing, a trend that will likely unwind over some longer period. This is particularly troublesome since consumers account for roughly 70% of the U.S. economy. Additionally, there is a real concern that the fiscal and monetary tools of the past will be less effective in stimulating demand during this crises, increasing our concern that this problem may simply be too large for government authorities to solve quickly.

We are pleased with the way our equity strategies performed in 2008, outperforming markets by a significant margin. We recognize that these strategies have declined in absolute terms, but at this point, we believe our investors have suffered minimal permanent impairment of capital. During this difficult period, we remain focused on limiting losses and continuing to protect capital.

While the longer-term picture is still unclear, we believe a reordering of global economic and political relationships are underway and possibly accelerating. More specifically, we are concerned about a resurgence in inflation, a resumption in the decline of the U.S. dollar, and continuing market volatility. Despite these concerns, we believe opportunities exist in several areas of the market:

- The problems in credit markets have created many attractive opportunities that our managers are exploiting. In many ways, given the hard catalysts and attractive valuations in this area, we find the debt markets more attractive than the equity markets.
- While deflation will likely be a major issue in the short run, we remain concerned about the potential for higher inflation further out. Despite this, we believe municipal bond yields, which have not increased substantially in response to the financial crisis compared to Treasuries,

offset this drag to a significant degree. As a result, we have partially reversed our long-standing underweight in fixed income assets.

- We continue to emphasize foreign stocks over U.S. stocks. More specifically: The rapidly growing emerging markets, especially the BRIC countries, have been the most devastated of all equity markets, sport the lowest valuation levels among stock markets and have the highest potential for earnings growth in the future. Our interest in China is an example. Additionally, our interest in Japan remains high, as it remains the cheapest market in the developed world. • Despite hedged strategies experiencing its worst quarter and year ever, we believe current spreads provide investors with a good opportunity over the coming quarters. We are still waiting to see if outflows in this area are the beginning of a secular unwinding of investor interest or simply a short-term reaction to recent performance and scandals such as the Madoff Ponzi scheme. Long-term performance in this category rests on the answer to this question.
- We continue to build real estate exposure, both in the U.S. and internationally. A number of secular trends from the institutionalization of the asset class, growing demand in Asia and generally greater opportunities to add value overseas continue to drive our interest. Real estate remains a highly inefficient market, allowing our managers to find discrete opportunities that can provide attractive returns. Valuations are falling providing better buying opportunities for our managers with whom we have substantial unfunded investment commitments.
- In private equity, we continue to prefer middle market buyouts to larger funds as the middle market and smaller funds are less overfunded and are able to buy companies at lower valuations. Venture capital also remains attractive as funding remains in balance with the opportunity set. Finally, investing in secondary funds has become significantly more interesting in a world of distressed sellers who may have over invested in illiquid strategies.