

Overview

Table of Contents

Market Commentary	4-5
Performance	
Markets Continued to Recover	6-7
Macro Environment	
The US Likely to Experience a Sluggish Recovery	8-9
Emerging Markets Expected to Return to Strong Growth in 2010	10
What's Next for the Fed?	11
The Dollar Suffered as Financial Conditions Normalized	12-13
Inflation is Still Muted, but Upside Risks Remain	14-15
A Tale of Two Credit Markets	16
Markets	
A Liquidity Fueled Rally?	17
Treasury Yields Defied Rising Equity Market	18-19
A Flight to Junk	20-21
Domestic Equities Appear Frothy Again	22-23
A Weak Dollar Propelled International Equities	24-25
Will Faster Growth Lead to Strong Returns?	26
REITS Surged Despite Commercial Real Estate Woes	27

Executive Summary

- Equity markets continued to stage a strong recovery in the third quarter with the riskiest assets posting the strongest gains. The rebound in markets has corresponded with a decline in the dollar.
- This environment presents challenges for investors. The rally seems to have outpaced the fundamentals, so it would not be surprising to see another down leg to the bear market. Yet, the Fed's monetary policy increases the opportunity cost of holding low risk assets. Additionally, the intermediate- to long-term inflation risk makes low risk assets unattractive for long-term investors seeking to preserve purchasing power net of spending.
- Given the prospective returns offered by Treasuries, we continue to recommend tilting fixed income portfolios towards investment-grade credit. We also favor TIPS over Treasuries. While we believe CPI inflation is likely to remain fairly low over the short- to intermediate-term, there is a greater risk of upside than downside inflation surprises.
- While short-term risk remains high, the long-term prospective return on equities is attractive relative to lower risk assets. We believe it is very likely that stocks will outperform Treasury bonds (and investment-grade bonds) over the next decade. Therefore, investors with a strong stomach should stay invested in equities and other risky assets, but should keep some dry powder available in case there is another leg to this bear market. We also advise aggressive rebalancing to targets.
 - We continue to recommend a tilt to large-cap quality growth stocks (characterized by relatively stable profits, healthy balance sheets, and intangible capital) both in the US and internationally.
 - International developed equities are trading at attractive valuations relative to the US.
 - Emerging market equity valuations are again looking stretched. We continue to recommend a modest overweight because they have more intermediate-term upside potential (because of potential currency appreciation and money flows) than developed equities.
- This environment could prove fruitful for skilled hedge fund managers. The challenging economic environment is likely to produce distinct winners and losers. There should be opportunities to capitalize on this in both credit and equities.
- With liquidity still a concern for many investors, illiquidity should pay better than usual. We encourage investors with the necessary flexibility to continue making private asset commitments. We see attractive opportunities in secondary private equity transactions, distressed credit, and distressed real estate (rescue or gap financing).
- REITS surged during the third quarter, but we still recommend avoiding the asset class given poor fundamentals and weak debt markets. Nevertheless, we believe there are going to be very attractive opportunities in commercial real estate. Fresh capital going into the sector today can take advantage of the distress.



Market Commentary

October 2009

Investors have been on a rollercoaster for the last two years. After suffering through a brutal 2008, investors endured even more losses during the first several weeks of this year. However, since early March, stocks have staged a massive rally. This has been a relief to investors from a financial perspective and a psychological standpoint. The global financial system seems to have been pulled back from the precipice, and a sense of relief has returned to financial markets. While the economy has improved and markets have recovered substantially, in some ways, the investment choices now facing institutions are more difficult than they were in the depths of the despair pervading October 2008 and March 2009.

Re-embracing Risk

In price-only terms, the 57% peak-to-trough decline in the S&P 500 made this the most severe bear market since the Great Depression. By comparison, since WW-II, the average peak-to-trough decline during bear markets was 28%. Most of the recent losses occurred in a six week period spanning from late August to mid-October, during which the S&P 500 declined 41%. The rebound in capital markets has been almost as amazing as the collapse, as the S&P 500 has surged 56% (ex-dividends) in a little over six months. As of quarter-end, it is up 19% on the year. However, the speed and strength of the rebound might obscure the fact that the S&P 500 is still 32% off its all-time high of 1565. Even after the sharpest rally since the Depression, the S&P 500 has only recovered about half its losses. Put differently, it needs to rise another 48% just to get back to the peak.

Foreign equities were hit with a double whammy during the crash as a strong dollar compounded losses. European stocks declined 54.5% in local currency terms and 63% in US\$ terms. Since the start of the rally, European stocks have slightly lagged domestic stocks in local currencies, but they have significantly outperformed in US\$ terms, rising 74%. Japanese stocks were hit harder during the bear market and lagged behind the rest of the world during the rally, although they have benefited from a strong yen. Measured in local currency terms, emerging markets fared similarly to the rest of the world during the sell-off; however, they declined 65.2% in US\$ terms. Emerging markets have led the recovery on optimism regarding their economic prospects, rising an astounding 106% in US\$ terms. Despite the strong rally, most global markets are still substantially below their October 2007 highs.

Generally, the riskier the asset, the greater the loss was during the bear market. Not surprisingly, the reverse has been true during the recovery. However, the degree to which this has occurred is surprising, given the fragile state of the banking system and the weak economic outlook.

Total Return (%)			
	Peak-to-Trough	Trough-to-9/30	Peak-to-9/30
S&P 500	(55.3)	58.2	(29.1)
Russell 2000	(58.5)	77.6	(26.3)
MSCI Europe (local currency)	(54.5)	56.1	(28.9)
MSCI Japan (local currency)	(61.3)	33.0	(48.5)
Emerging Markets (local currency)	(58.0)	83.3	(23.0)
Trade Weighted Dollar	21.4	(10.1)	8.3
Oil	(78.4)	124.8	(51.4)
Gold (based on S&P dates)	25.0	9.3	35.6
Spreads			
Large Vs. Small	3.2	(19.4)	(2.8)
Growth vs. Value	8.9	(11.7)	9.1
High Quality vs. Low Quality	13.4	(25.7)	5.6
Low Beta (<1) vs. High Beta (>1)	9.6	(51.7)	(8.1)
I/G Bonds (ex. fincls) vs. HY Bonds	29.5	(33.9)	10.3

While this has clearly been a junk rally, higher quality names have generally fared better since the start of the bear market, though by a surprisingly small margin. Growth stocks outperformed value stocks during the crash (value indexes were much more heavily weighted towards financials), but have lagged during the rally, trailing by 11.7 percentage points. However, since the October 2007 peak, growth stocks have outperformed value stocks by more than 9 percentage points (-24.4 vs. -33.5). High-quality stocks held up much better than low quality stocks during the sell-off. While they have trailed during the rally (rising 40.1% vs. a gain of 65.8% for low quality stocks), for the full period quality stocks have outperformed by nearly 6 percentage points. Given the default outlook, the rally in junk bonds appears overdone. Since March, high yield bonds have gained an astonishing 51% while investment-grade bonds (ex-financials) returned 17.2%. For the full period, however, non-financial investment grade bonds have risen 18.1% vs. a gain of 7.8% for high yield debt.

Small-cap stocks have performed surprisingly well since the start of the bear market. Large-caps stocks only outperformed small-caps stocks by 320 basis points during the sell-off. Exposure to money center banks weighed on the S&P 500 during the crash. Non-financial companies in the S&P 500 outperformed non-financial companies in the Russell 2000 by nearly 10 percentage points. Since March 9, the Russell 2000 has outperformed the S&P 500 by 1940 basis points (77.6% vs. 58.2%). Since the peak in October 2007, small-caps have outperformed large-caps by a cumulative 4 percentage points. Given that small-caps were substantially more overvalued than large caps at the start of the bear market, we would have expected the S&P 500 to outperform. Going forward, we continue to recommend underweighting small-caps as they remain expensive on an absolute and relative basis.

While most institutional portfolios remain substantially below their high, the market's rebound has certainly brought relief. Forgotten is the fact that, just a mere six months ago we were contemplating the nationalization of several of our largest financial and banking institutions. While we're still in a precarious environment, most no longer feel the financial system is collapsing around their ears. At the March 9 low, we estimate that the typical endowment and foundation was down 13% for 2009 and 35% from the

beginning of 2008. The market's 60% rebound from the low has lifted 2009 returns well into positive territory. Through September, the average institution is up roughly 15% for 2009. The improvement in credit markets has also reduced liquidity concerns. Overall, however, the average institution is probably still down about 15% from the beginning of 2008, which is similar to the loss experienced during the 2000/2002 bear market.

What Now?

After the gyrations of the past couple of years, many investors are understandably uneasy with near-term prospects of the stock market. While the doomsday economic and financial scenarios seem off-the-table at present, we can't be certain that the worst is behind us. The market collapsed 45% in the first two months of the 1929 bear market, but rebounded 47% over the next five months through the spring of 1930. The rebound probably led many investors to believe the worst was past. Of course, we now know that was a sucker's rally. The market eventually bottomed two years later, in June 1932, with an 86% cumulative decline. More recently, the S&P 500 was down 38% from the March 2000 high following the 9/11 attacks. A rebound lifted the market 21%. Nevertheless, another downward lurch began in March 2002, which cut an additional one-third from the market by the ultimate September 2002 low.

And there is still a lot to worry about. While the economy is apparently recovering from very depressed levels, we are not out of the woods yet. It is difficult to see a quick return to robust economic growth given the state of household finances. Consumer spending is likely to remain weak as households move to reduce debt levels and rebuild savings. It seems the economy is likely to grow below trend for several years, with the risk of more downturns. Further, substantial loan losses remain to be realized by banks, which could keep credit markets strained for years, weighing on a recovery. On top of that, we don't know the ultimate consequences of unprecedented government interventions. By using debt to cure excess indebtedness, are we simply kicking the can down the road, setting up an even bigger collapse? Could excessively easy monetary policy lead to a dollar collapse and hyperinflation? How will the Federal government pay its promised future obligations?

Balancing short-term risk with long-term needs is always difficult. But it may be even more so because of policy initiatives and macro imbalances. By holding interest rates at low levels to help heal the financial system, the Federal Reserve is making it very unattractive for savers and investors to hold low risk assets. Cash rates, of course, are virtually zero. Ten-year Treasuries yield just 3.3%. Even if inflation remains mild over the next decade, institutions are looking at a real return of less than 1.5%, hardly sufficient to maintain purchasing power after a 5% spending rate. Not only are absolute yields low, but the aggressive actions of the Fed, along with the future needs of the Treasury, make upside inflation surprises a real risk. This is especially damaging to low-risk bond investors (although TIPS offer some protection). To meet long-term goals, institutions must eventually invest in riskier assets. However, valuations are beginning to appear stretched again. Still, prospective returns for equities classes remain reasonably attractive relative to bonds. The normalized P/E ratio on the S&P 500 (based on an average profit margins on sales) has increased to around 18, which is slightly above average. The current P/E ratio suggests a future real return of approximately 5.5% (1/18), which is decent, particularly relative to bond yields.

It is precisely these dynamics that are creating a conundrum for today's investors. Any action to reduce the risk of losses in the short-term is imprudent from a long-term perspective. Selling equities to buy Treasuries or corporate bonds will help cushion the blow of another downturn, but it means earning very little and reduces the probability of meeting long-term return needs. Further, if inflation risks are realized, liquidating equities could result in erosion of purchasing power. Conversely, prudent steps for the long-term means maintaining significant short-term risk. To achieve a typical return objective, institutions must tilt their portfolio toward risky assets to avoid losing purchasing power. However, with short-term risks elevated, risky assets could get clobbered again. Perhaps investors could reduce equities now to sidestep a correction and reinvest at lower prices. Of course, that is much easier said than done. For one, we can't be certain that there will be an opportunity to buy equities at materially lower prices. Secondly, if a correction happens, investors must decide when to get back in. The market's sharp rebound this year shows the challenge of timing re-entry.

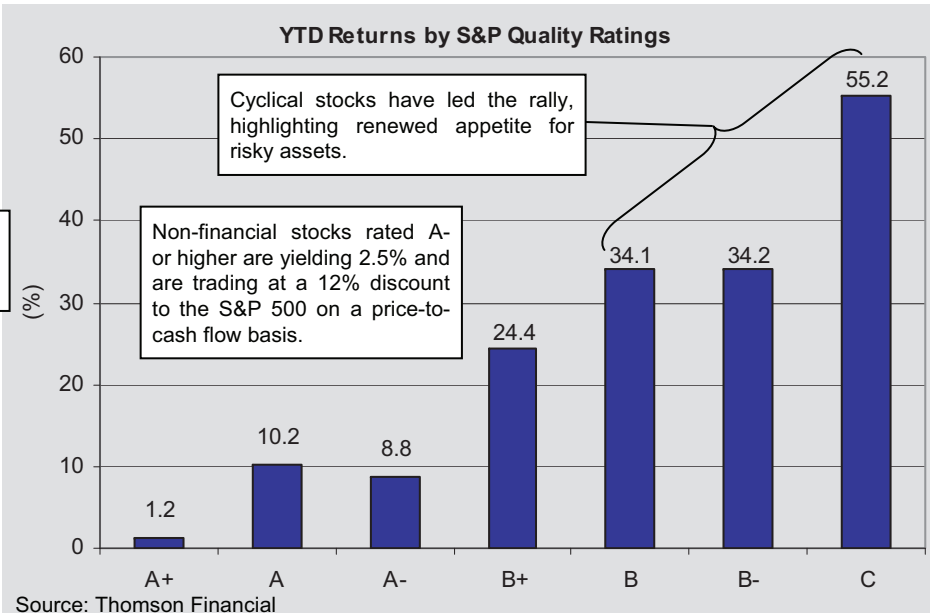
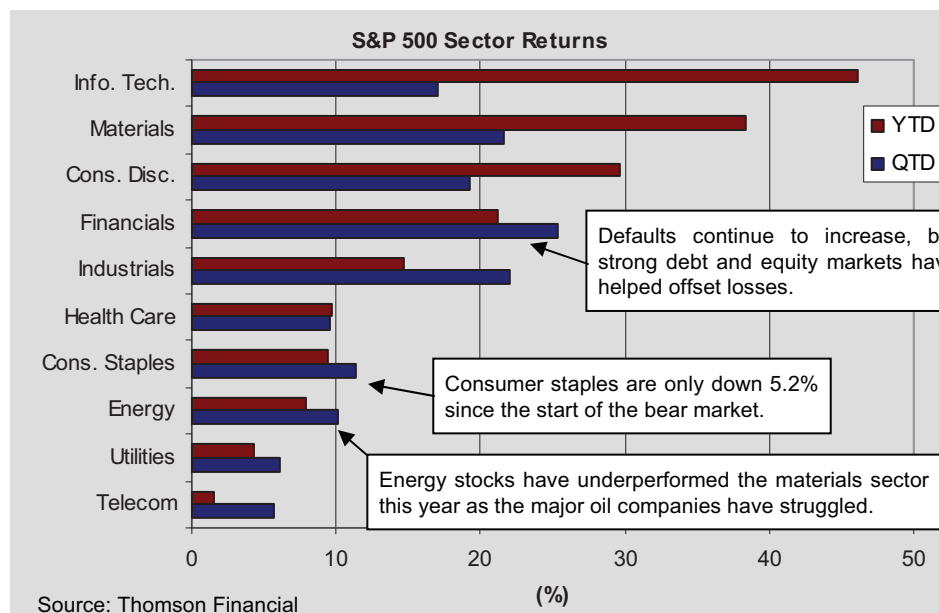
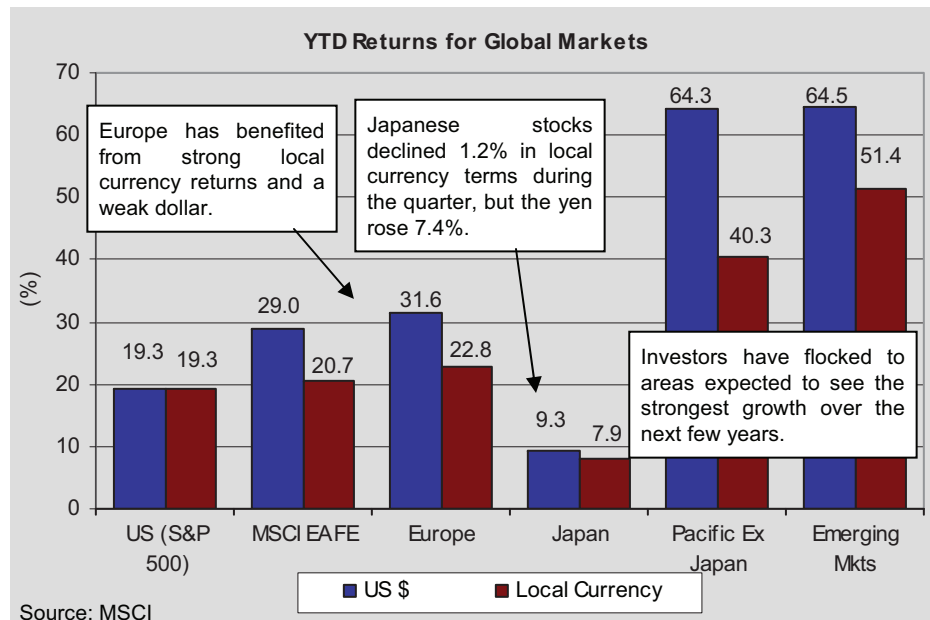
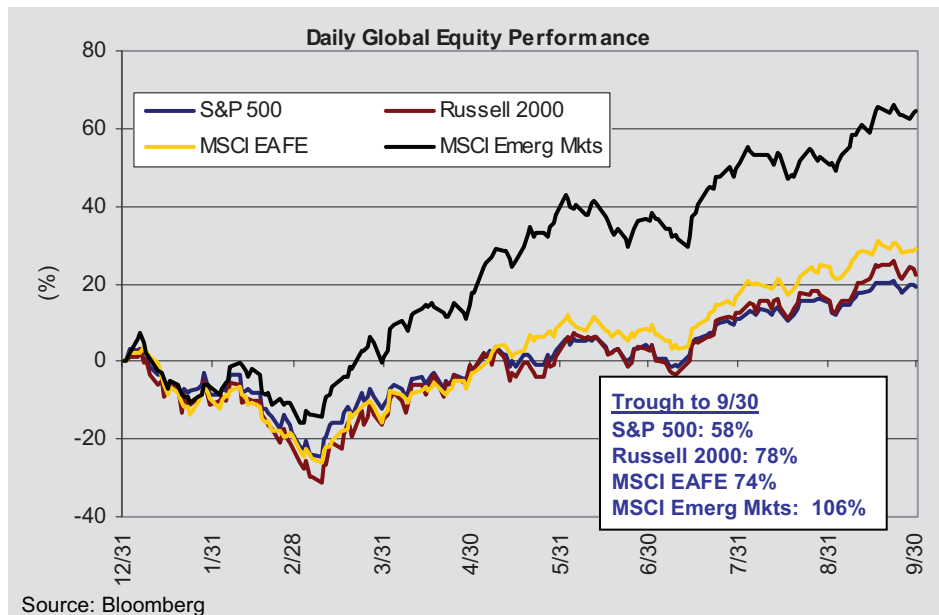
In determining the balance between reducing short-term downside risk and maximizing the probability of achieving long-term return objectives, investors may wish to take a step back and re-evaluate their return requirements and risk tolerance levels. Institutions should also evaluate their ability to withstand additional heavy losses. If the market returns to the bear market lows, we estimate that the average endowment and foundation will suffer a decline of about 25% from the end of the third quarter. At the end of prior severe bear markets, the S&P 500's P/E ratio traded down to the single digits. Were that to happen again, the average institution could suffer a loss of about 35% from the end of the third quarter, and a cumulative loss of 43%. While we think both scenarios are unlikely, it is instructive to consider the ramifications of both. What would the effect be on liquidity, spending, debt covenants, operating budgets, and donors? Undoubtedly, such losses would be disruptive to virtually all institutions. More important is the question of whether the losses would be survivable.

Those that cannot bear another severe downturn should consider using the rally as an opportunity to reduce exposure to stocks, recognizing this means sacrificing the ability to meet long-term objectives, at least for now. For the typical institution, however, it may make more sense to stay invested in a diversified mix of assets. While this means accepting the possibility of more losses and volatility in the short-term, it offers the best chance of meeting an institution's long-term return needs.

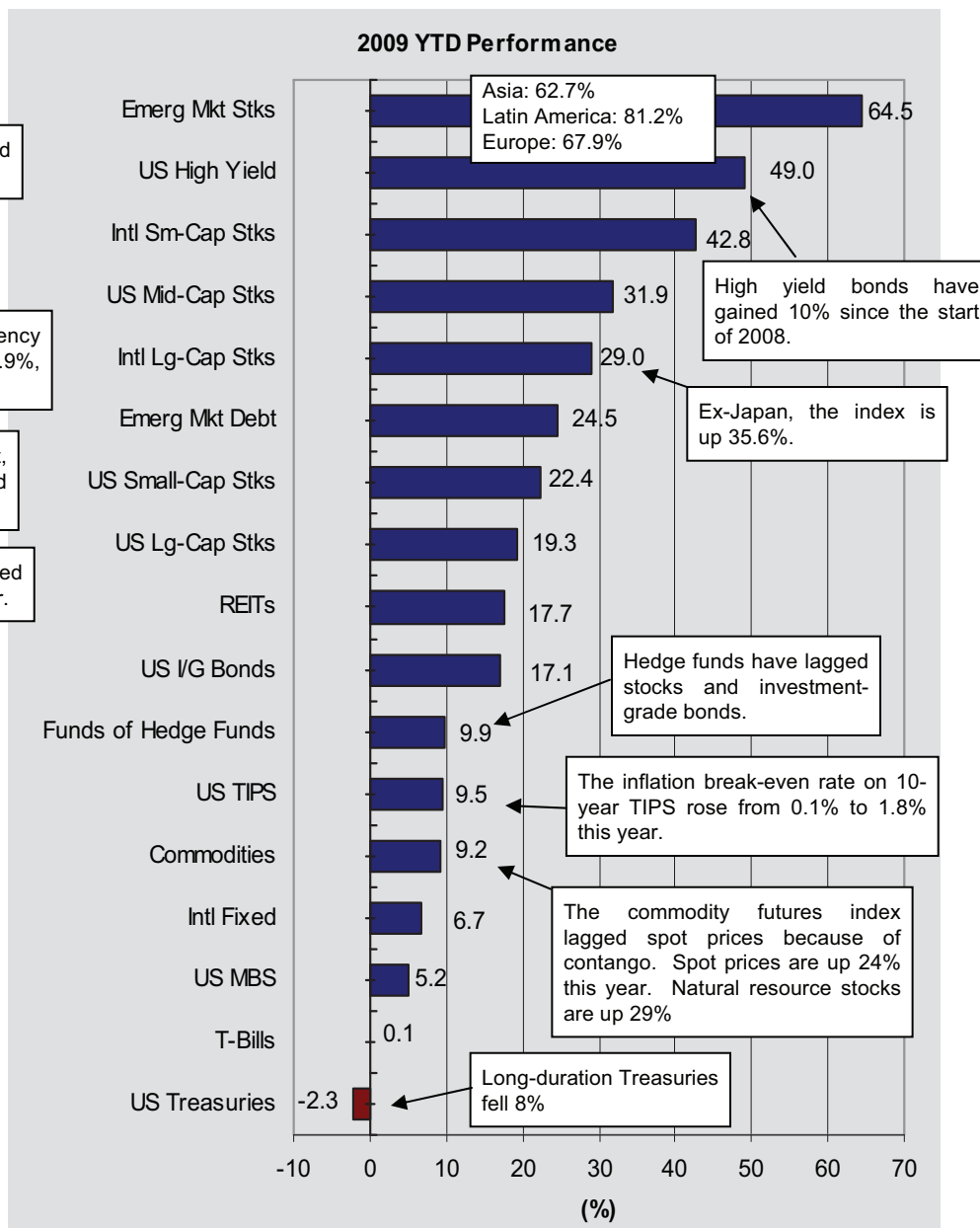
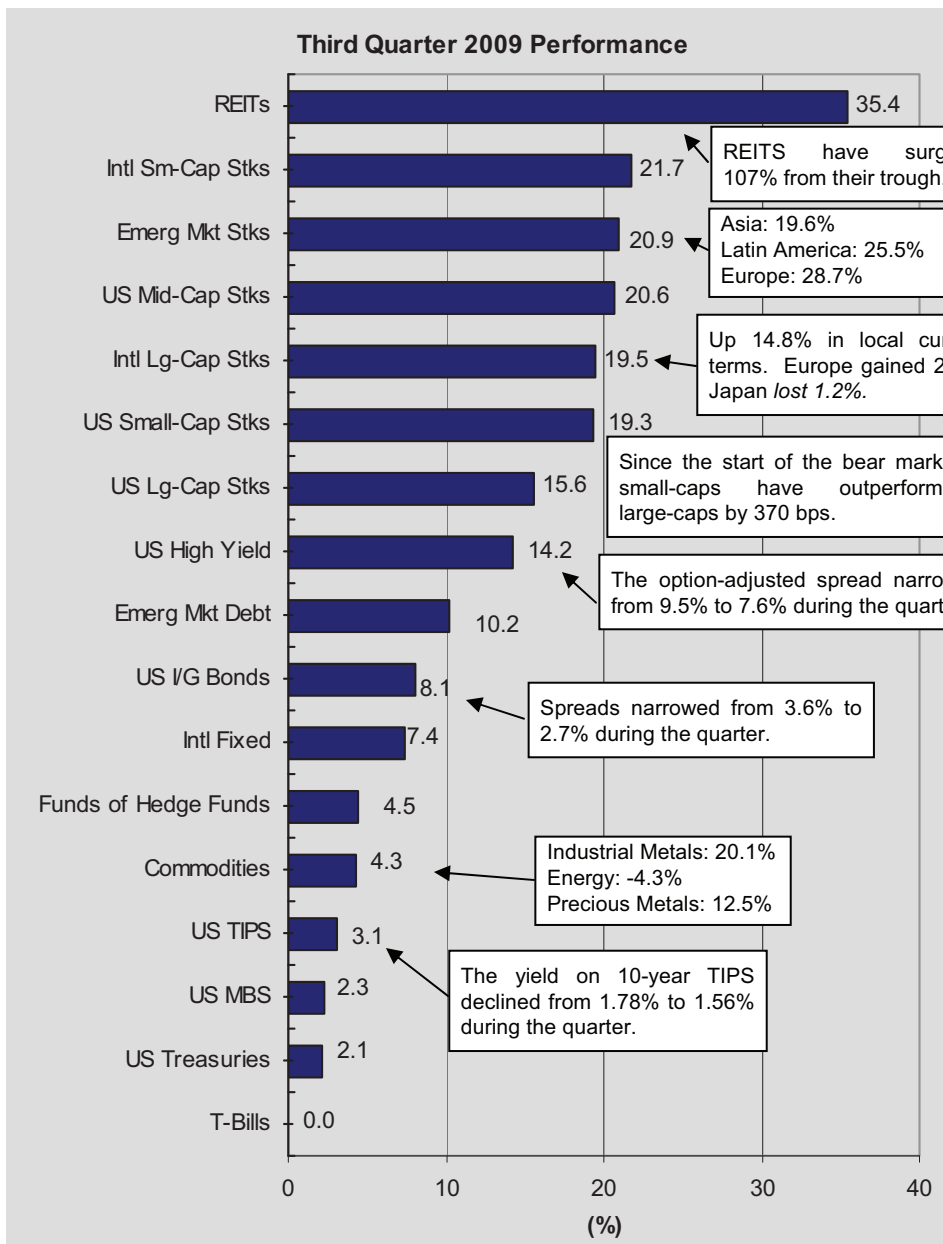
Recap

While institutions should maintain a long-term focus, they must remain cognizant of short-term risks. We continue to recommend holding one year of spending and capital calls in cash or other low-risk assets. Additionally, rebalancing back to policy frequently can help institutions take advantage of volatility. Clients should also consider trimming equity risk at the margin and tilting equity exposure to high quality companies both domestically and internationally. While markets have basically shot straight up after the crash, investors should be prepared for a bumpy ride over the next several years. Volatility is likely to remain high for an extended period of time and the path to economic recovery will not be smooth. Rather than agonizing over every market turn, institutions should remain focused on the long-term, maintain diversified portfolios, and be ready to take advantage of opportunities as they present themselves. Institutions that follow this course should emerge in the strongest shape.

Markets Continued to Recover



Markets Continued to Recover (cont.)

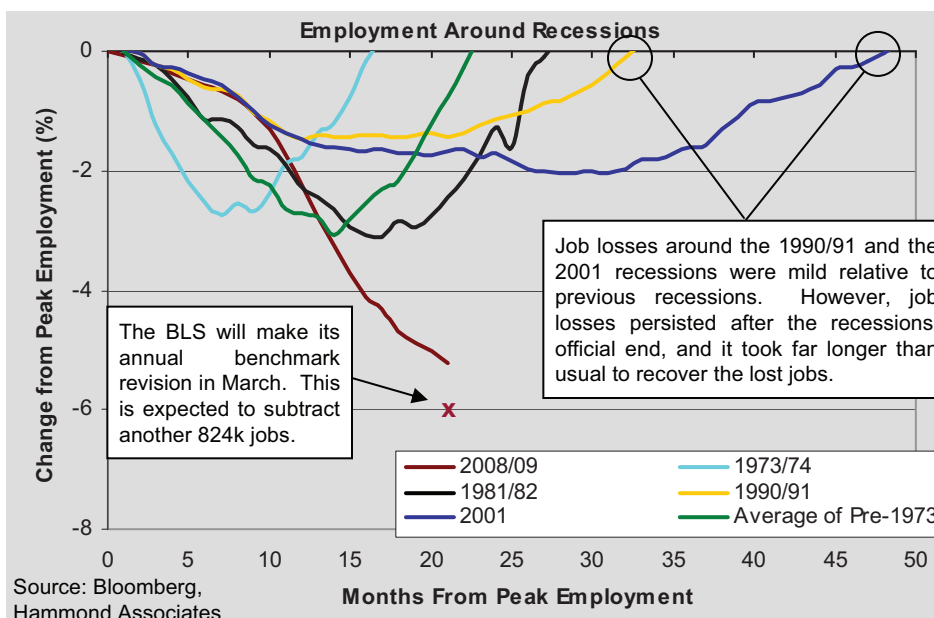
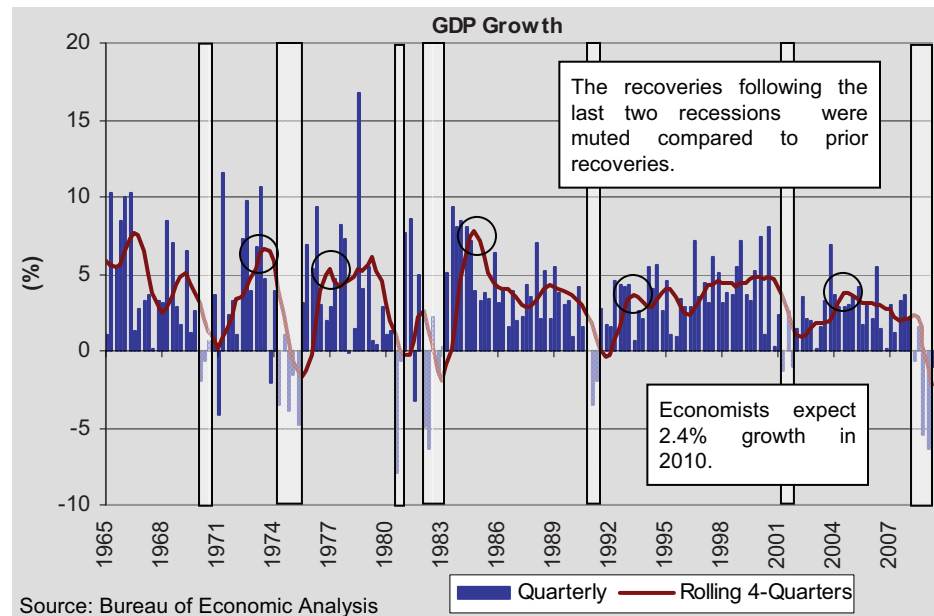


The US Likely to Experience a Sluggish Recovery

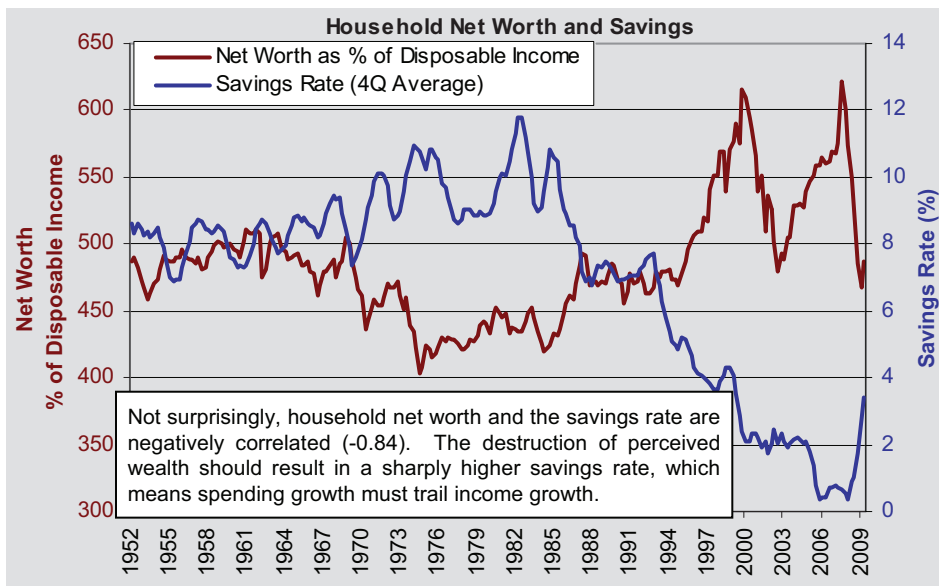
- Economic prospects improved during the quarter. Economists polled by Bloomberg estimate that the GDP expanded at a 3.2% annualized rate in the third quarter. Fourth quarter growth is forecasted to come in at 2.4%. It appears that the Great Recession is finally over (although the NBER has not yet made the official determination), and the focus now turns to the trajectory of the recovery. In this regard, it's difficult to be optimistic.
- The miserable state of the job market will continue to weigh on the economy. Employers cut an average of 253,000 jobs per month in the third quarter. While this is only one-third of the first quarter rate, it is still a significant contraction. Economists often tag employment as a lagging indicator, but the nature of this downturn may make this time different. It's hard to see a robust recovery with this level of unemployment, and the recovery in employment may take frustratingly long.

 - Total employment has declined by 5.2% so far in this recession, making it the worst of the post-war period, and the unemployment rate reached 9.8% in September. A broader measure of unemployment that includes part-time workers seeking full-time jobs and discouraged workers who have stopped looking is over seven points higher at 17.0%.
 - Job cuts are likely to continue well into 2010. Since 125,000 jobs per month need to be created to absorb new entrants in the labor force, the unemployment rate could continue to rise through most of 2010.
 - The recovery in jobs following the last two, relatively mild, recessions took much longer than previous recessions. This is probably because of the shift in employment from manufacturing to services. Given the severity of this downturn, the recovery in jobs will probably take even longer. For example, a record 5.4% of the labor force has been unemployed for 15 weeks or longer (this peaked at 4.2% during the 1981/82 recession).
- Business investment is very depressed and inventories are thin, so a short-term snap back is to be expected. However, it's hard to see businesses aggressively increasing capital spending because of a glut of capacity and an uncertain demand outlook.

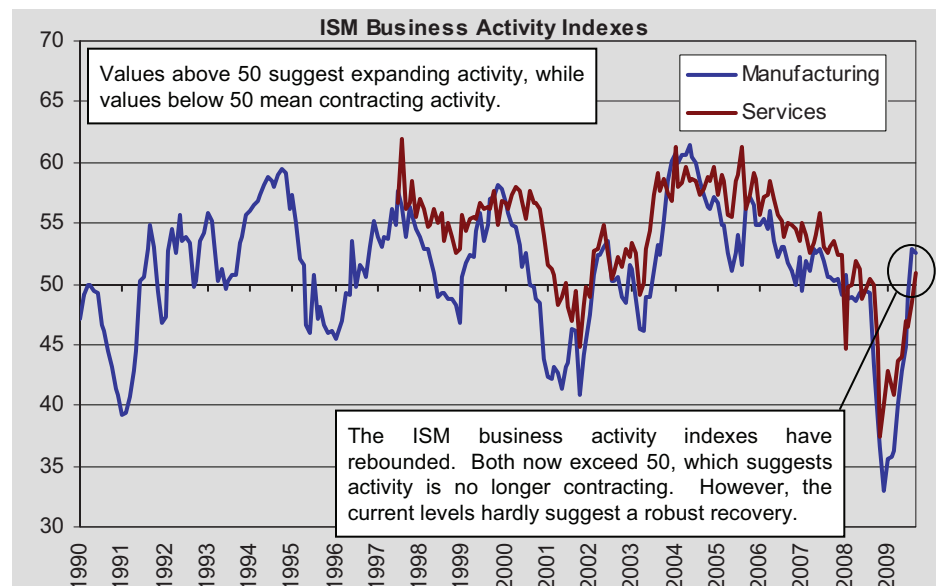
 - Past recessions gave rise to pent-up demand from households and a sharp rebound in spending. The negative wealth effect from housing and equity markets, along with a low household savings rate and weak wage growth, will probably keep a damper on spending.
 - Exports are a potential positive with the renewed weakness in the dollar and higher growth in emerging market countries. However, at only 11% of GDP, they aren't likely to drive a near-term recovery.
- Government intervention helped to prevent this downturn from turning calamitous. However, it has done little to address the economy's underlying problems of overconsumption and excess debt, and it is in fact encouraging the same behavior that led to this crisis. The massive future obligations of the government risks crowding out private activity, which could lower long-term growth potential.
- This was not a typical cyclical downturn. It was precipitated by 20+ years of excessive debt growth and overconsumption. The rebalancing of the economy is likely to weigh on growth for several years, but the economy will be fundamentally more sound after this transition occurs. The growing role of the government risks unintended consequences that could delay this necessary adjustment.



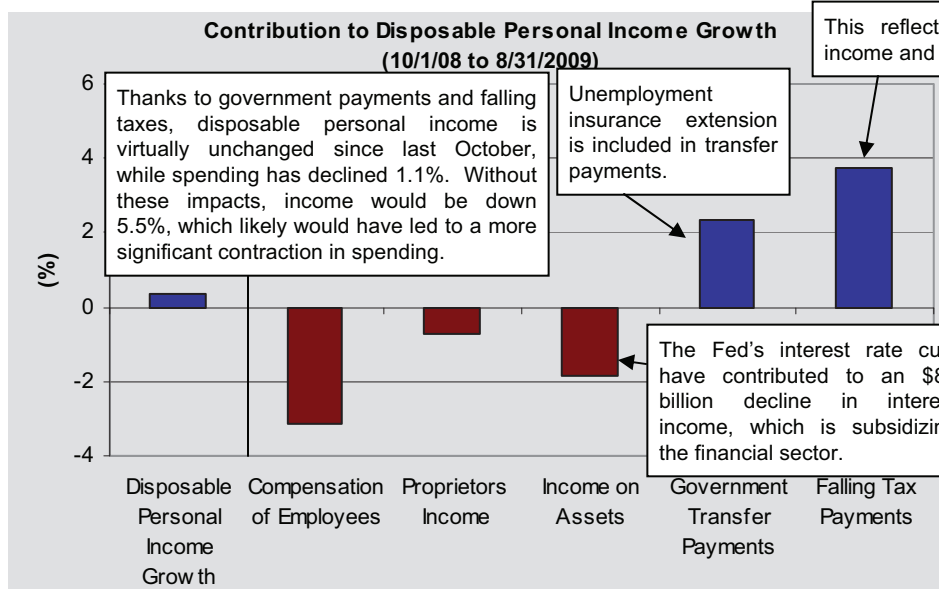
The US Likely to Experience a Sluggish Recovery (cont)



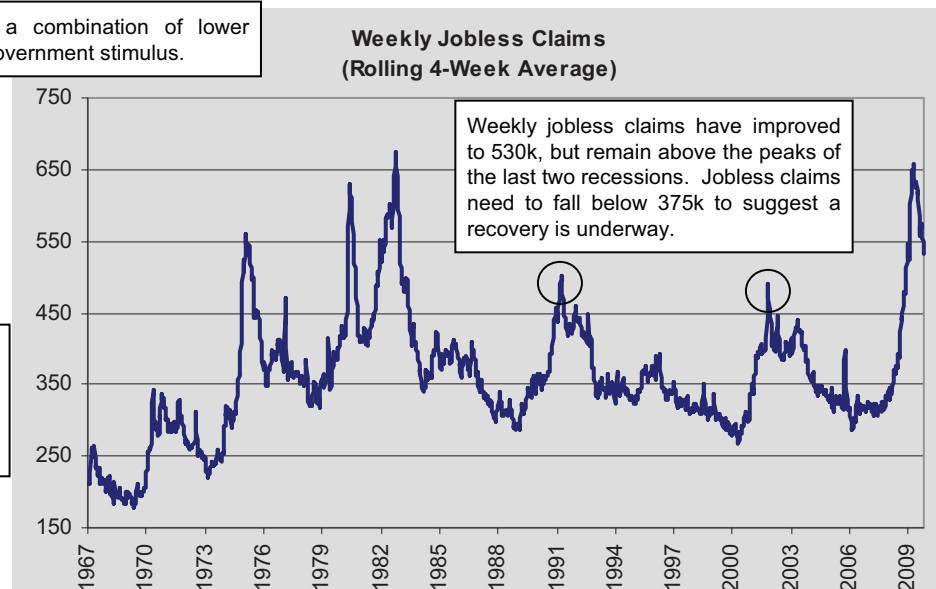
Source: Federal Reserve



Source: Bloomberg



Source: Bureau of Economic Analysis, Hammond Associates



Source: Bloomberg