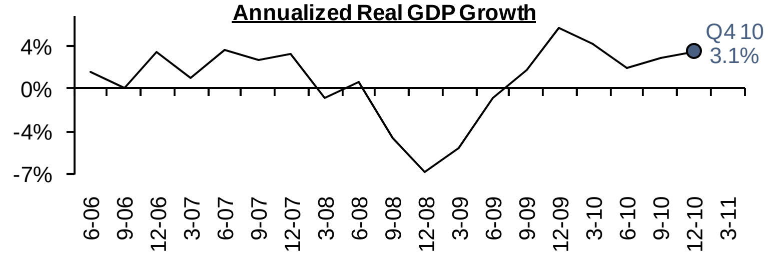
1st Quarter

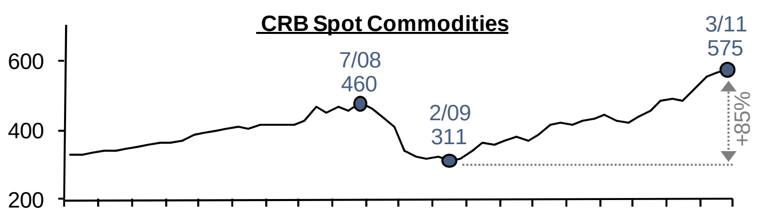
MARKET Recap

The Economy: *"Prosperity and Austerity"*

US economic growth continued to accelerate in the fourth quarter, driven by increased private-sector activity. Residential and non-residential fixed investment and exports contributed positively, as did a sharp downturn in imports, while decreased government spending at all levels detracted from GDP growth.

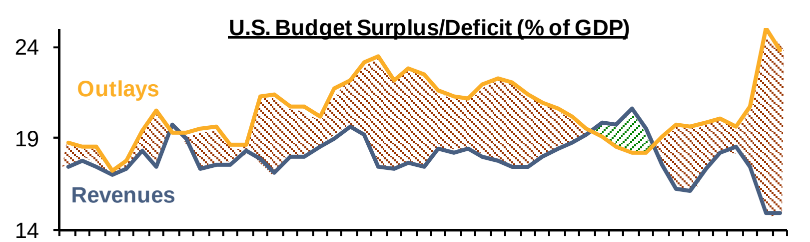


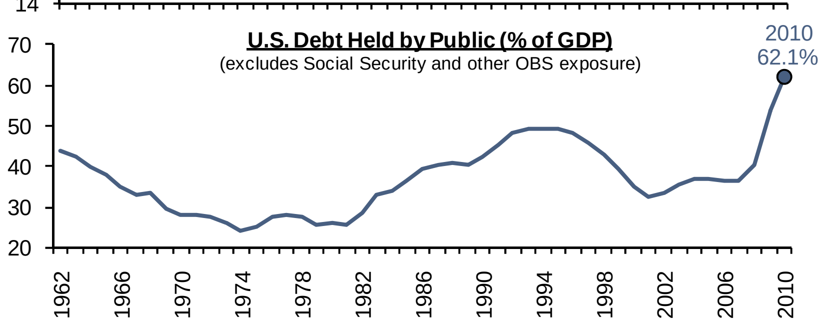
Personal consumption expenditures increased each month of Q4, and continued to increase through February, although the character of the increase changed. For October and November, the bulk of increased PCE reflected real increases in purchases, while from December through February over half of the increase was due to inflation. Growth in the conveniently-defined "core" CPI remained tame at 1.1% (annualized as of February), while the CPI with energy and food accelerated to a 2.1% pace (from 1.5% in December and 1.1% in September).



Commodity prices reached record highs in March, driven by base metals, agricultural commodities, and oil. Unemployment continued to decline gradually from a peak of 10.1% in October 2009 to 8.8%. We draw the general conclusion that quantitative easing has generated the expected effects: increased economic activity and inflation. So far, surplus dollars have tended to migrate overseas (mainly to emerging markets) and into the commodities markets rather than into consumer prices. We expect to gradually import inflation into local prices, indeed the process has begun, but the pace and magnitude has thus far been undramatic.

These facts set the stage for a vicious debate on fiscal policy, the beginning of which coincides with the 2011 budget cycle and 2012 presidential election process. As we've discussed in past issues, no one (including the US in aggregate) can indefinitely spend more than they earn. Deficits must be financed, and the resulting debt must ultimately be addressed through inflation, austerity, or default. Current posturing aside, default or "restructuring" is not on the table for the US government -- it is for other governments, local and foreign. Some combination of inflation and austerity most certainly is on the table, arriving sooner than is tasteful for those that benefit from loose spending. Chief among those, politicians from both parties, have bought their careers with deficit spending. Those same officials are now locked in a partisan debate over how much to curtail "discretionary" spending, which major parts of the budget such as entitlements and defense outlays.

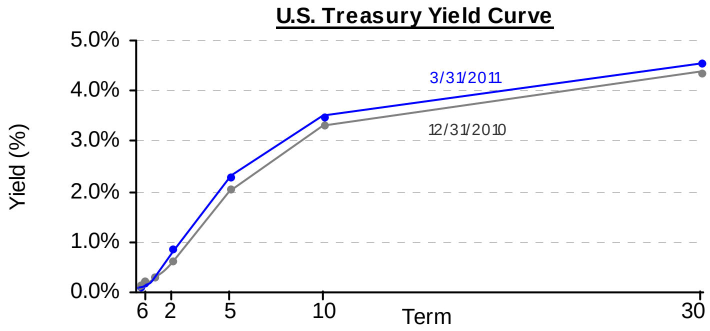




The most aggressive proposal aims to cut about 1.5% from spending, which barely begins to address the deficit, much less the accumulated debt. While we believe budget cuts and tax increases will eventually emerge (in more earnest after the 2012 election), the sheer magnitude of the problem drives our expectation of continued inflation, with concomitant asset bubbles. Risk-taking investors should be appropriately wary.

The US Bond Market

Treasury prices fell over the first quarter of 2011, pushing yields up moderately on all but the shortest duration notes. The yield on the benchmark 10-year note ended the quarter at 3.47%, up 17 basis points from the prior quarter. The shape of the yield curve remained much the same with the 2 – 10 year spread narrowing by just 5 basis points. However, the moderate changes belie a bumpier path over the quarter. In February, 10-year yields peaked above 3.70% on improving economic data. By mid-March, yields dropped to 3.21% in a flight to quality after the earthquake in Japan. Despite all the negative global headlines, AA-rated bond spreads and BB-rated high yield spreads fell by approximately 10 basis points and approximately 40 basis points, respectively. This is a continuation of a strengthening trend that started in 2Q 2009, and spreads on AA-rated bonds are close to their 10-year average.



Source: Bloomberg LP

In an attempt to find equilibrium between promoting economic growth and market inflation expectations, Fed officials continued heated monetary policy debate throughout the quarter. At the end of the quarter, several of the central bank's more hawkish officials emphasized the need to reverse the Fed's easy monetary policy as well as the benefits of setting a formal inflation target. This was balanced by Federal Reserve Bank of New York President William Dudley, who warned against tightening monetary policy too quickly. With encouraging economic news and the unemployment rate dipping, it seems likely that the Fed will tighten by early next year.

While predicting the timing of any Fed move is always difficult, futures contracts are factoring in a 60% probability of a rate hike by February 2012. In addition, the difference between yields on 10-year notes and Treasury Inflation Protected Securities widened to 248 basis points by the end of the quarter from 182 basis points six months prior, according to Bloomberg. This spread is generally seen as a gauge of expectations for average inflation over the coming decade. The 10-year average is 200 basis points.

Q1 Index Total Returns	
BarCap Aggregate	0.42%
BarCap Interm. Gov't	0.02%
BarCap Long Gov't	-0.86%
BarCap Interm. Credit	0.99%
BarCap Long Credit	0.64%
BarCap High Yield	3.88%

The first quarter of 2011 was one of the busiest for the issuance of corporate debt, with companies taking advantage of low interest rates, tight spreads, and investor demand. According to Bloomberg, almost $400 billion of corporate debt was issued over the quarter. Further, the quarter saw only 3 corporate defaults, down from 29 in the first quarter of 2010, according to Standard & Poor's. With yields on government and other investment-grade debt continuing near record lows, junk bond sales were also on the rise with $88 billion of high-yield bond issuance coming to market in the first quarter of 2011. However, investor demand was not the only driver of the increased offerings. With the Basel Committee on Banking Supervision requiring more capital held against risky assets, banks have become less willing to offer loans forcing more firms to turn to debt issuance. According to the Fed, commercial and industrial loans at America's banks totaled $1.4 trillion as of March 16, down from a peak of $1.6 trillion in October 2008.

The US Stock Market

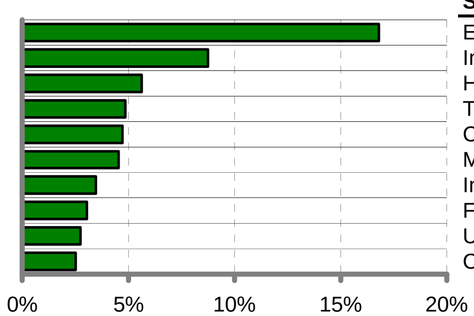
US equities experienced the best first quarter in more than a decade. But stocks slipped slightly just before the quarter close when Federal Reserve Bank of Minneapolis President Narayana Kocherlakota remarked that key interest rates may have to rise in late 2011. Equities rallied for the first half of January amid strong earnings reports, and the economic recovery seemed well on its way. But by the end of January, anti-government protests in Egypt caused the largest single day decline in over two months. The US market encountered several more challenges throughout the quarter including rising commodity prices, an earthquake in Japan, and geopolitical unrest resulting in another US military offensive in the Middle East. Oil climbed over $100 per barrel and protests in Libya and Saudi Arabia, as well as the destruction created by Japan's earthquake and tsunami and resulting nuclear crisis caused stocks to tumble further. Despite the upheaval investors remained optimistic and all major US stock indices finished up for the third consecutive quarter.

Q1 Index Total Returns			
Largecap Stocks		**Midcap Stocks**	
S&P 500	5.92%	S&P Midcap 400	9.36%
Russell 1000	6.24%	Russell Midcap	7.63%
Growth	6.03%	Growth	7.85%
Value	6.46%	Value	7.42%
Broad Markets		**Smallcap Stocks**	
Russell 3000	6.38%	S&P Smallcap 600	7.71%
DJ Wilshire 5000	6.00%	Russell 2000	7.94%
		Growth	9.24%
		Value	6.60%

As investors continued to take on risk, smallcap and midcap stocks outperformed largecap offerings for another quarter. Six out of ten smallcap sectors returned more than the S&P 500, as did eight out of ten midcap sectors. Within the small and midcap space growth stocks continued to flourish while value stocks won out for larger-cap indices.

Within all capitalizations, energy dominated all other sectors. Oil continued its upward trend ending the quarter at $106.72 per barrel amid concerns that the Libyan conflict and unrest in the Middle East could spread to other oil exporters such as Saudi Arabia, putting pressure on the supply of oil. As oil gained, energy stocks rose across producers, service providers, exploration firms, and elsewhere in the energy sector such as coal and natural gas conglomerates. Retail stocks fell in particular after Wal-Mart CEO Bill Simon mentioned that prices could be affected by inflation later this year. Financials were weak across all capitalizations. Commercial banks were hit hard this quarter as investors continued to shy away from the sector's uncertainties. The future path of interest rates added to investor concerns. Many fear that if the Fed decides to raise rates the yield curve will flatten, creating lower margins for banks.

S&P 500 Economic Group Components - Total Return



Sector	1Q2011
Energy	16.80%
Industrials	8.75%
Health Care	5.62%
Telecom	4.85%
Consumer Disc.	4.71%
Materials	4.54%
Info Tech	3.47%
Financials	3.04%
Utilities	2.74%
Consumer Staples	2.52%

Source: Standard & Poor's

After several quarters of cost-cutting, corporate balance sheets are considered to be the strongest they have been in 30 years. But even with this excess cash, companies seem tentative to invest. Concerned with the stability of the recovery, the new regulatory environment, and the potential of increased taxes, businesses are electing to sit on cash until uncertainty abates. M&A activity in Q1 dropped 22% from the same period last year. However, due to increased valuations the decrease in the number of acquisitions actually represented an overall $1.5 billion increase in associated assets.

IPO activity continued to increase in the first quarter of 2011 as the US saw 11 venture-backed companies go public, raising $768 million among them. This was an improvement over the 8 IPOs that raised $711 million during the first quarter of 2010 according to the Dow Jones Venture Source. The pipeline looks strong with 45 US venture-backed companies currently in IPO registration and talks of large tech companies like LinkedIn, Facebook, Groupon, Skype, Pandora and others to enter the public markets this year.

Overseas Markets

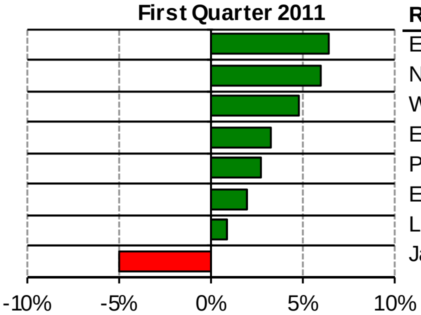
Developments in global markets came fast and furious during the quarter as events with wide-ranging global implications occurred. Volatility spiked up as the Eurozone peripherals continued to dominate the news over insolvency and bailout concerns. In the Far East, the impact of the earthquake, tsunami, and nuclear melt-down has yet to be calculated in terms of effect on the global economy. Amidst all of the turmoil, developed markets seemed to roll with the punches, outperforming their emerging market peers in general.

News out of the Eurozone remained focused on the PIIGS (Portugal, Ireland, Italy, Greece, and Spain). In February, yields on Portuguese government bonds soared to levels perceived as unsustainable, prompting intervention by the European Central Bank. The yield premium to hold 10-year Portuguese bonds over German bunds reached a euro-era high of more than 7.6% as the ECB started buying Portuguese to cool market fears. Concerns that the country would be forced to seek a bailout similar to Greece and Ireland seemed to persist. The cost of insuring sovereign debt continued to increase for fiscally-strapped peripheral countries, with the spread on Portuguese CDS widening 15 basis points. Concerns about whether Ireland's newly-elected government would force senior bondholders to accept haircuts put added pressure on Spanish and Italian bond yields on fears that it could spark a stampede out of bank debt across Europe. A summit of European Union leaders ended badly as a German proposal to increase the competitiveness of the euro-zone's weakest economies in return for backing a revamp of the region's rescue fund fell flat. Previously agreed-to austerity measures taken by the peripherals don't appear to be improving the fiscal situation. Quarter-over-quarter, Greece's economy contracted 1.4% in the fourth quarter, Portugal's fell 0.3%, Spain rose a modest 0.2%. Even with all of the negative news in the sector, German consumer sentiment continued to improve amid rising wage and employment data. However, this news should be taken with a grain of salt, as the IFO survey of German business sentiment fell through the middle of the quarter. It remains to be seen which sentiment indicator, consumer or business, will carry the day. The MSCI Germany Index was up 7.5%. French consumer spending on manufactured goods rose in February, lifted by prospects for accelerating growth and job creation. Spending advanced 0.9% from January, when it fell a revised 0.3%, according to INSEE, the national statistics office. Consensus predictions had been for a 0.5% gain. Spending advanced 5.5% from a year earlier and jobless claims fell for a second month in February. Sentiment among manufacturers rose to a three-year high in March as increasing export orders spurred hiring. The MSCI France Index was up 10.6%.

Japan was overcome by the events of March 11th. Earthquake damage to a number of nuclear power plants further hurt confidence in the country as the power grid sustained a severe hit to capacity. The problems with the damaged nuclear reactors continue as of this writing, with the country trying to cope with meltdowns and extreme radiation leaks. It is difficult to assess the impact; however, estimates are that the areas most affected by the disaster produce about 8% of Japan's GDP. It seems obvious that GDP will take a hit in 2011, although rebuilding is ultimately expected to be stimulative. Directly in the aftermath of the quake, Japan's central bank injected 20 trillion yen ($245 billion) into the money markets in an effort to help calm financial markets. The move was designed to ensure that banks have enough liquidity to meet a surge in demand from companies and households. In addition to all of its other problems, the yen remains strong which could put further downward pressure on Japan's export oriented economy. All things considered, the MSCI Japan index was down modestly.

Net Total Return of Selected MSCI Regional Indices

First Quarter 2011



Region	1Q11
Europe	6.46%
North America	5.99%
World Index	4.80%
EAFE	3.36%
Pacific ex Japan	2.76%
Emerging Markets	2.05%
Latin America	0.88%
Japan	-4.93%

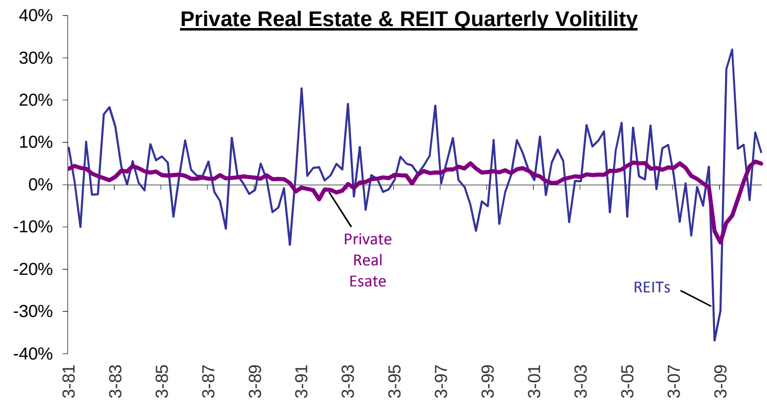
As expected, China continued its contractionary monetary policy throughout the quarter to address inflationary pressures. The central bank steadily increased the minimum cash reserves commercial banks must hold, known as the reserve ratio, three times during the quarter. In aggregate, the reserve ratio rose 150 basis points to 20%. In addition, China hiked interest rates to 6.06%, or 50 basis points over the previous quarter. To put China's growth in perspective, the country is poised to become the world's 2nd largest tourism-market in 2020, estimated at roughly $838 billion. According to a Boston Consulting Group study, the rest of the world's tourism industry is not ready for the whopping 381% growth expected out of Chinese vacationers abroad over the next decade. At home, economic strength has led to persistent inflationary pressures. At the end of March, Chinese consumers cleared supermarket shelves of soap, laundry detergent, and shampoo after the media broke a story of 5 – 15% price increases. At a meeting with Chinese officials in late March, US Treasury Secretary Timothy Geithner continued to criticize China's handling of its currency exchange rate. The yuan-US dollar peg has in effect exported the United States expansionary monetary policy (QE2) to the Chinese economy spurring a boom and potential asset bubble. The MSCI China Index was up moderately for the quarter, returning 2.9%.

Elsewhere in the emerging markets, the Far East recovery was stalled as a result of the earthquake in Japan. Besides the effects of the quake, the region experienced three forces en route to an economic recovery: strong consumer spending and high capital inflows coupled with increased inflationary pressures. Domestic demand has been robust and continues to be a key driver in Emerging Asia's role of leading the global recovery, with year over year GDP increasing 6% and 9% over the last two years. Strong foreign capital investments chasing yield have flowed into, and stimulated, Far East economies. In Cambodia, two main economic industries – garment exports and tourism – helped improve overall economic growth. A mounting concern to Far East government policy officials continues to be inflation. During the quarter, Indonesian and other policymakers from Asia met with the IMF to discuss how best to address the massive capital inflows. Far East central banks and governments face policy and monetary challenges in balancing a robust economic environment while containing inflationary pressures. Overall, Far East equity markets were mixed with MSCI returns ranging from +7.3% in Korea to -4.3% in Taiwan.

Latin American emerging markets experienced continued growth. Brazil's Economic Activity Index registered a 3.7% increase during 2010 and Argentina's economy grew by an aggressive 9%, swiftly overcoming the impact of the international crisis. Growth has been driven by strong domestic consumption, a rise in employment and wages, and higher levels of available credit. Similar to the Far East, strong economic growth has been overshadowed by rising prices. Brazil's twelve-month trailing inflation rate rose 140 basis points to 5.9%. In response, Brazil's Central Bank increased its target rate 50 basis points to 11.75%. Since March 2010, Brazil's target rate has increased 300 basis points in an effort to cool its economy. Argentina's Central Bank expressed concerns over rising prices in its 2011 Economic Outlook and will keep a close watch on growth. The MSCI Brazil Index was up 2.6% for the quarter while the MSCI Argentina index fell 12%.

Focus On: *Real Estate & Diversification*

"Don't put all your eggs in one basket." Sound advice, but the global market meltdown in 2007-2008 brought to light some of the limitations of diversification among public equity markets. During this time, correlations among asset classes converged, meaning that there was little benefit to diversifying among different asset classes; no matter where you were invested you were going to lose. In terms of Modern Portfolio Theory, non-correlated returns are the gold standard as investors search for ways to increase returns without materially increasing risk through investment in asset classes that respond differently to market forces. Recently, defined contribution (e.g., 401(k)) plan fiduciaries have been looking to lessons learned in the defined benefit (pension) world – diversifying into alternative asset classes. Retirement plan sponsors have started to consider real estate options as diversifiers and hedges against inflation. But is the asset class translatable to DC plans in a meaningful way?



Data sources: NCREIF, NAREIT

The Asset Class

Investors are generally interested in commercial real estate, a broad term that encapsulates a number of property types including office buildings, apartment buildings, industrial property, healthcare facilities, storage units, and a myriad of others. Real estate investors seek rental income as well as capital gains from increases in property values over time.

The market can be divided into public and private real estate. Private real estate funds invest in various types of commercial properties usually through pooled investment vehicles, units of which are valued based on the appraised value of the underlying real estate holdings. Real estate investment trusts (REITs) – companies that own and operate real estate holdings on behalf of shareholders - are the most common public real estate structures. REIT shares are traded on stock exchanges and, although the underlying real estate holdings are illiquid, the REIT shares are continuously valued and traded. At any given time REITs will trade at a significant premium or discount to underlying appraised values. Essentially, a REIT substitutes the pricing judgment of an expert appraiser with the pricing judgment of the market at large.

10 Year Asset Correlations							
	Large Cap Equity	Small Cap Equity	Foreign Equity	US Bonds	Emerging Markets	Real Estate	REITs
Large Cap Equity	1.00						
Small Cap Equity	0.94	1.00					
Foreign Equity	0.92	0.86	1.00				
US Bonds	-0.36	-0.39	-0.24	1.00			
Emerging Markets	0.87	0.83	0.90	-0.23	1.00		
Private Real Estate	0.19	0.18	0.16	-0.16	0.10	1.00	
REITs	0.72	0.78	0.70	-0.01	0.61	0.24	1.00

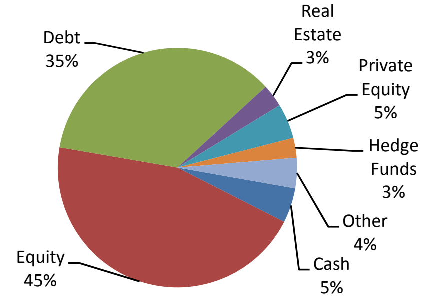
Professional appraisals are performed in a number of ways including the cost approach which estimates replacement costs plus the value of land, the income approach which estimates cashflows from the property, and the sales approach which tries to find observable data from recent comparable sales. Appraisals occur infrequently and tend to lag actual price shifts over the real estate cycle. Because of lower valuation frequency and conservative bias in appraisal processes, private real estate structures tend to exhibit much lower valuation volatility than do public structures.

Another outgrowth of the appraisal-based process is autocorrelation, a statistic which describes the correlation of a time series with its own past and future values. Private real estate often exhibits autocorrelation, or persistence, in which successive appraisals move prices slowly and in the same direction, leading lower correlations with other asset classes. The price of lower volatility and correlation, however, is limited liquidity. During time periods where real estate prices decline, investors that want out must enter exit queues and wait until liquidity becomes available. Faster exits are possible through secondary markets, however these markets are very inefficient and the associated discounts during bear markets can be quite steep.

Pension Investors

Private real estate investment has been used by long-duration investors like pension plans and life insurers for many years as a diversifier to enhance performance, hedge against inflation, and match long-term liabilities. Real estate is capital intensive, requiring large amounts of cash as well as access to financing (leverage), which pension plans and large financial organizations (e.g. insurance companies) typically have. A 2009 survey by TowersWatson showed that the average corporate pension plan allocated 3.1% of total assets to real estate with about 2.5% of the assets invested in generally illiquid investments. Larger corporate pension plans typically have an allocation to the asset class approaching 10%.

Long-duration investors consider and weigh a number of factors when making real estate investments: vehicle type, market cycles, valuation methods, financing, and property management. With their longer history in dealing with the asset class, institutional investors are more familiar with the underlying issues and better equipped to make decisions under risk and take advantage of characteristics such as autocorrelation as they seek higher returns with lower volatility.



Their long-term focus also allows them the luxury of riding out the expected and unexpected "bumps" in a typical real estate market cycle rendering liquidity more of a second tier consideration. The "smoothed" nature of private real estate is beneficial to insurers and pension plan sponsors, both of which seek higher returns but are averse to the impact of asset volatility on their earnings, surplus, or funding. Lower correlation with other portfolio holdings helps further dampen volatility. Since liquidity is often a secondary concern for these investors, the risk control benefit comes at a relatively low price.

Defined Contribution Investors

As fiduciaries have looked for ways to diversify fund line-ups away from their US equity dominated plan structures, real estate has been one of the alternative asset classes they have looked at adding. The 2009 Plan Sponsor Survey by the Profit Sharing Council of America showed that about one-fifth of large 401(k) plans offered a real estate option.

The decision to add real estate is more challenging for defined contribution fiduciaries versus their institutional counterparts. Real estate is a relatively new asset class within the DC market, and fiduciaries don't have a long history in analyzing the asset class or dealing with the unique issues related to the investment such as volatility, liquidity, correlation and valuation. More importantly, defined contribution plan participants have become used to daily liquidity under all market conditions. While not a legal requirement per se, plan sponsors reasonably tend to avoid investments that can "lock up" during bad markets. Not surprisingly, REIT funds are the predominant vehicle.

But a close inspection of REIT funds reveals some interesting points for a plan sponsor to consider. The most significant, and perhaps counter-intuitive, observation is that REIT performance correlates highly with small cap stocks. In terms of volatility, REITs also have a risk profile closer to that of stocks. While public real estate does have a number of positive attributes, including liquidity and fee transparency, the correlation and volatility characteristics imply there is not much to be gained by a REIT investment that could not be gained through a diversified investment in smallcap stocks. Indeed, REITs are part of the public equity (stock) universe, and are included in benchmark indices like the Russell 2000.

Given defined contribution plan sponsors' sensitivity to the liquidity and valuation issues in private real estate, the market has responded with a small set of hybrid funds that combine the characteristics of public and private real estate investments. The private real estate component provides the diversification benefit while the public real estate component provides a level of liquidity to support the transactional nature of the retirement market. The merging of public and private real estate creates a complex structure that does not provide the more pure exposure that pension plan investors get, but it helps moderate some of the issues particular to the asset class that make DC plan sponsors uncomfortable.

To Add or Not To Add? That is the Question...

While their pension peers have a long history and comfort level with the unique risks associated with real estate investing, defined contribution fiduciaries have less experience with the nuances of the asset class and are confronted by different challenges. However, the issues surrounding real estate are not necessarily a reason to say "no" to the asset class. Plan sponsors must to be willing to accept more complex product structures (e.g., hybrid funds) if they want to achieve similar benefits to those that pension investors get.

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