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January 2012 Economic Update & Market Commentary

This is a time to reflect on 2011 and what may be in store for us in 2012 and beyond. 2011 was filled with enough unique global macro events and capital market reactions to permanently frighten even the most confident long term investors. There were plenty of major events and uncertainties making headlines: the ongoing Eurozone sovereign debt and banking crises, the heartache of the earthquake in Japan and the immediate but temporary disruption to the global supply chain, the continuous procrastination of U.S. elected officials to deal with U.S. deficits, 2012 presidential election politics, the Arab spring, the flight to Treasuries with multiple "risk on, risk off" trading periods, and volatility in global commodity prices. What does all this mean?

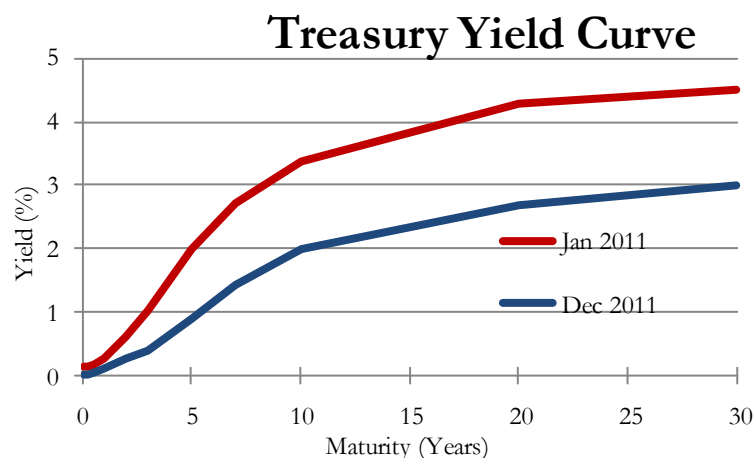
A Global Perspective - What's Lies Ahead: We expect 2012 to be a year of slowing global growth, with wide divergences between countries and regions. These divergences could well be a cause of market volatility and performance dispersion in currencies, equity and fixed income markets around the world. We expect overall global growth to slow from about 3.0% in 2011 to 2.5% in 2012. For 2013, a modest recovery in global growth is likely.

We also believe the euro zone sovereign crisis will linger and likely escalate in 2012, provoking a sufficiently strong policy response from the ECB and creditor governments to prevent euro zone disintegration and a string of disorderly sovereign debt defaults. Sovereign spreads will remain unusually wide during 2012 and Treasuries may continue to be a global safe haven keeping nominal yields at historically low levels.

The euro zone is already falling back into recession, with negative quarter over quarter growth in Q4. We expect real GDP in the euro zone to drop by at least 1.0% in 2012. By contrast, we expect modest but sustained growth in the U.S. in 2012 and beyond, and still relatively strong but slowing growth in 2012 for emerging Asia, Latin America, Africa and the Middle East. In all, we expect sluggish global growth in the advanced economies (around 1% year over year), with emerging market growth of about 5.0% for 2012.

As a result, *the extent to which global growth is China-dependent will increase.* The lagged effect of past domestic tightening there and slowing export growth are likely to cool China's growth below 9% year over year in Q4 2011 and beyond. Nevertheless, *China will continue to account for a huge share of global growth.*

Of course, there are major headwinds in this modestly positive outlook. First, our forecast assumes the Euro crisis escalates and then is contained by policy responses. This forecast is subject to considerable risks – most of them on the downside. On the upside however, it is possible that the ECB and creditor nations may be willing to commit themselves publicly to provide extraordinarily large assistance early enough to prevent sovereign spreads widening further, although we regard this as rather unlikely. On the downside, it is possible that there may not be a viable overlap between what the ECB and creditor nations are prepared to offer and what Greece and other periphery countries need to avoid early defaults. We put the chance of one or more countries leaving the EMU in 2012-13 at 25%. If this happens it would probably be a Greek exit, but there is also a small chance that Germany balks at the costs of sustaining the EMU, and walks out with other core European countries.





Second, the experience of 2008-09 highlights that bank deleveraging during economic weakness (which is likely in Europe) can cause a large drop in economic activity. Third, we are worried that emerging Asia may experience a slowdown in exports to Europe, compounded by the drag from previous domestic policy tightening. In particular, restrictions on home purchases in China are producing a sharp slowdown in housing activity. If there is a deeper downturn in emerging Asia, this will probably produce sharper loosening in monetary, credit and fiscal policies overseas. Fourth, there will be a limited decline in imbalances between current account surplus and deficit countries, both globally and in the euro zone. The continuation of these imbalances creates additional downside risks to the outlook. For example, the necessary recycling of excess savings from current account surplus countries may not occur smoothly, and deficit countries may turn to protectionism or disruptive foreign exchange policies to try and regain the growth lost to imports.

United States

It may not be so obvious, but the U.S. economy has been getting better. After a fairly miserable first half of the year, the economy grew by 2.0% in the third quarter and is likely to accelerate by more than 3.0% in the final quarter. There are signs that recent momentum could carry into next year: job openings are on the rise, the unemployment rate is trending down, consumer confidence has begun to rebound and corporate profits relative to GDP are at their highest level in over six decades. However, the economy and markets do not operate in isolation.

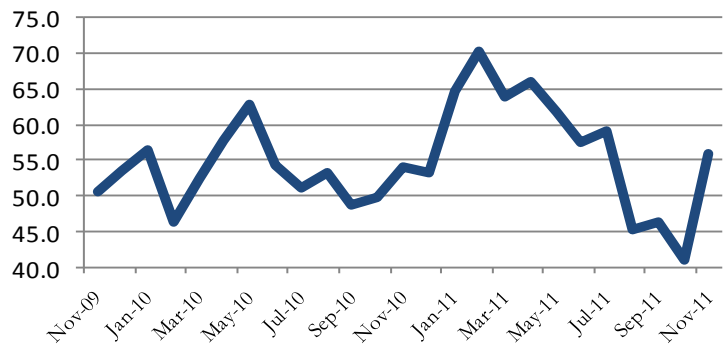
In earlier commentaries, we identified two major risks to the U.S. outlook: the financial crisis in Europe and fiscal restraint from Capitol Hill. On both fronts, the risks have intensified in the last few months if anything.

Despite all the uncertainties, U.S. economic growth has picked up. Auto output and sales have rebounded as Japanese supply lines have reopened and production has increased. Earlier weather disruptions have eased and the partial reversal of oil price spikes has helped discretionary household income. Consumer spending is rising at the fastest rate in a year and business spending on equipment is growing at a double-digit rate.

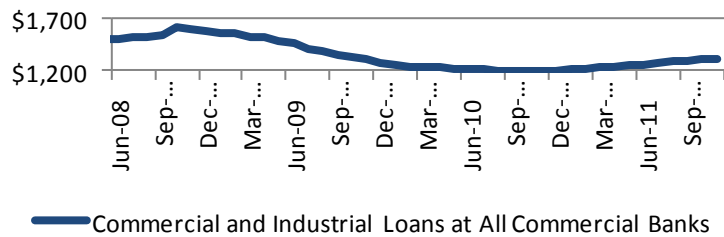
The financial supports for growth are improving slowly but overall conditions still represent a modest headwind. Bank credit is on the rise, led by a growth in business lending, while consumer credit card limits are edging up. However, financial stress indicators remain elevated and contagion from the European sovereign debt crisis could feed through to the U.S. banking system. Volatile markets caution us that investors lack confidence in policymakers' abilities to head off contagion.

The lack of any revival in housing remains the key shortfall in the broader U.S. recovery and prospects favor very meager gains in homebuilding. Although home prices have steadied in many parts of the country, and affordability is high, vacancies and inventories remain stubbornly high, while more than a quarter of mortgages are under water. The condition of the

Consumer Confidence



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housing market remains a significant headwind to economic growth. The housing market's impact on household wealth, confidence and job portability remain a problem. The relative weakness in construction and financial services sectors along with ongoing retrenchment in the state and local government spending have contributed to our slow employment gains due to the large impact they have on overall employment. *We expect the jobless rate to decline very little in 2012.* Although the recovery has netted 2.3 million new jobs since early 2010, the employment-to-population ratio is near a 30-year low and there are four unemployed workers for each job opening. Despite strong profits and historically-wide operating margins that typically signal stronger labor markets, U.S. policy uncertainties and the fragile global recovery are likely exacerbating firms' reluctance to expand and hire.

We expect recent signs of easing inflation to continue next year. Core inflation has been below 2% for sometime now. Earlier factory bottlenecks have loosened; pipeline prices have declined; unit labor costs have stopped falling but wage growth remains modest and consumers have resisted business attempts to flex any significant new pricing power.

Monetary policy is likely to remain supportive throughout 2012. With inflation within desired ranges and unemployment stubbornly high, it is hard to see how federal funds rates can rise until sometime beyond 2013. While it is true that recent Federal Reserve easing moves (e.g. QE1 and QE2) have had favorable effects, financial conditions remain weaker than historically normal at this stage in a recovery. Given all the uncertainties cited above, Fed officials have kept the door open for even further expansion of their balance sheets. That said, their likely first option will be to use communications strategies to extend accommodation rather than real overt actions.

What seems more likely to be in the cards as a major headwind curtailing growth, is the fiscal restraint in the public sector over the next few years. The failure to reach an budget agreement in Congress means that under current law, steep automatic spending cuts are scheduled for January 2013. We would guess that the automatic spending caps will actually be reversed or replaced with less front-loaded cuts before they come into effect; but, the mere anticipation of the cuts is likely to make some reductions in government spending unavoidable. This headwind to the economy, in combination with spending cuts as part of the debt-ceiling deal, reductions in infrastructure spending and declines in state and local government aid will likely reduce economic growth in 2012 by 0.5 percentage points.

While gridlock is likely to continue to characterize the U.S political scene over the next year, the election in late 2012 may serve as a catalyst for more decisive post-election action on some of the outstanding U.S. fiscal questions. ***The bottom line is that U.S. fiscal policy restraint is likely to be a drag on economic growth for many years to come.*** And, while the federal government absolutely needs to address its long term deficit issues, there is a risk that spending could be cut too much and too soon, sucking demand out of the economy at a time when the private sector is still finding its feet. This will be a fine line that bears watching.

All told, the U.S. economy continues to grow, and has even shown some encouraging resilience over the last few months. Still, while progress has been made, pitfalls continue to mark the road to recovery. These pitfalls are likely to make headlines and be a source of market volatility.

Euro Area

We expect the euro zone sovereign debt and banking crisis to intensify further in 2012, with sovereign yield spreads vs. German Bunds remaining high in many euro zone countries, and many countries in the euro zone moving into recession. We do not, however, expect the euro area to break up in 2012 or the following years, nor do we expect the disorderly default of any euro zone country. The risk that either or both of these disaster scenarios materialize has, however, risen to a non-negligible 25% in our estimation. Rather, we think at this point, greater fiscal integration will need to occur.

.We expect two or more insolvent sovereigns (Greece, Portugal and possibly Ireland) to undergo orderly debt restructuring in 2012-13 – this is a point we have been making for nearly two years. We also expect a “ring-fencing” of the illiquid but most likely solvent sovereigns (Italy, Spain, Belgium, France and Austria) through greater ECB involvement as lender of last resort, through enhanced euro zone-wide fiscal facilities and through extra-EU assistance, most likely organized through the IMF. Finally we expect fiscal support, through national governments or through common euro zone or EU institutions or facilities (such as the European Financial Stability Facility), for bank recapitalization. We also expect the euro area countries to commit to and take the



first steps towards deeper fiscal integration to prevent and mitigate future fiscal debacles. This ring-fencing will need to be on a grand scale similar to the trillions committed in the U.S. by government officials so it won't come easily and without plenty of headline risk. Incremental fiscal tightening, structural reforms, tight financial conditions and a continued 'uncertainty overhang' will strongly weigh on domestic demand and *push the euro zone into recession in 2012 and 2013.*

China

Chinese GDP growth is now expected to account for over 30% of global GDP growth in 2011-2012 versus a 22% contribution to global growth in 2010. We remain reasonably optimistic about China's prospects, but we think there are two downside risks to China's economic growth, both of which can have feedback loop with each other: *external and domestic shocks.*

China may be less exposed to external shocks than it was pre-2007, but its vulnerability shouldn't be underestimated. Both China's exports to GDP has been declining over the years, demonstrating a greater contribution from domestic demand, especially investment. But by looking at exports to GDP share alone, we may be underestimating the extent to which China is more vulnerable to external demand slowdown if the domestic value added of China's exports is rising over time. China's vulnerability to domestic shocks is due to the rapid expansion of total financing in the past three years. As of 3Q 2011, the stock of total financing to GDP ratio rose to 175% of GDP in 2011 vs. 122% of GDP in 2008. Concerns arise from three major sources: *local government indebtedness, a 'hard landing' in the property sector and rising delinquencies.*

We believe that China has a reasonable set of tools to deal with these large scale risks. Although China has less policy flexibility than in 2008, authorities still have significant fiscal flexibility. The government's response to the global recession was to deliver a powerful credit stimulus, which produced positive results. Any future stimulus is likely to be delivered via central-government-funded fiscal efforts. The size could be meaningful, but we doubt it will be anywhere close to the scale announced in late 2008 (12%-16% of GDP spread over three years).

Summary: 2011 was a year of halting recovery in the U.S. that finished on a high note for the year. There are however plenty of headwinds for the U.S. economy looking ahead. On balance we believe that continued subdued growth is likely in the U.S. Large scale macro events in Europe and Japan had major impacts on economic activity and market behavior around the world in 2011.

There is no reason to believe in 2012 the European saga will resolve itself and there will be plenty of headline risk along the way to what we believe will be a longer term resolution. That said, continued debt uncertainty and fiscal restraint in Europe is leading them into recession now. Emerging Asian and Latin American economies will be impacted by these events in Europe and they are loosening monetary policy to combat this impact as we speak.



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Happy New Year!

The New Year is especially welcome after the endurance test that 2011 became. Politicians in Europe and the U.S. have left the sideshow tent and taken center stage. For now, the U.S. economy is performing better than Europe.

There's little doubt that Europe's economy will be weaker in 2012. The only question is how much weaker. Recent actions by the European central bank suggest that the risk of a European depression, at least within the next three years, is very low. But, the market is betting on a European recession.

The market's main concern is that the European crisis of confidence will get worse before it gets better. Economic forecasts for Europe are projecting a slow or no growth 2012 followed by slow to modest growth in 2013. Our view is slightly more pessimistic. Credit is the lifeblood of an economy. In Europe, government debt is the primary asset on the banks' balance sheet. As long as the market questions the quality of European government debt, European banks will stay cautious. If banks are less willing to lend, the European economy will drag.

Bond holders are liquidating European debt due to concerns about the budget deficit. This forces the European governments to reduce spending to bring down their annual budget deficits. This process will continue until bond investors are convinced that the deficits are sustainable.

When developed economies like Europe or the U.S. tighten their belt, emerging market economies like Asia and Latin America decelerate. International markets reflected this in 2011:

Market 2011 % Return

S&P 500 +1.6
MSCI World -6.4
Europe -11.5
Germany -12.9
France -17.5
Russia -19.8
Spain -17.6
Italy -27.9

Market 2011 % Return

EAFE -14.2
Emerging Markets -13.9
Asia -15.5
Latin America -11.8
Brazil -15.8
China -27.7
India -22.6

In spite of the unsettling volatility in the U.S. stock market, the economy has shown surprising strength over the last six months. The economic recovery generated 1.6

million jobs in 2011, and consumer confidence is slowly improving. Optimists assert that the U.S. has "decoupled" from Europe, and that in spite of the slowdown across the Atlantic, the U.S. economy should grow at least two-percent over the next year.

The biggest question facing investors in 2012 is whether Europe will gain from the U.S. experience in 2008 and successfully implement a policy that prevents a Lehman style banking collapse. If we assume that Europe slides into a recession, but is able to avoid a banking crisis, the odds that the U.S. and the rest of the world can side-step a recession improve greatly.

The Eurozone represents seventeen percent of the global economy. The most troubled economies, Greece, Italy, Spain and Portugal represent less than nine percent of the global economy. Continuing recovery in the U.S. should be enough to carry the global economy until Europe stabilizes.



After maintaining sizable portfolio holdings in European and emerging market economies, we spent most of the year reducing our exposure to non-U.S. companies. As long as investors stay cautious, they will emphasize U.S. stocks as a safe-haven. In 2010, the most aggressive segments of the market like small stocks and emerging market stocks substantially outperformed higher quality companies. The reverse was true in 2011.

The result of our move out of many emerging market and international companies was substantial. Our multi-strategy growth portfolios outperformed the global stock benchmark by more than five-percent in 2011. Companies with low volatility, that pay a high dividend, and that generate most of their revenues domestically led the market. The Utility index was the best performing index in the world. This is likely to continue until investors are convinced of the recovery's sustainability.

Four years have passed since the Great Recession hit and took out 8.7 million jobs. Each month of strong job

creation increases the hope that the U.S. may be in a virtuous cycle of job growth, healthier spending and higher demand. As long as there is excess capacity in the economy, this process can feed on itself. There is no shortage of long-term concerns, but for the next few years, if the headwinds from Europe aren't overwhelming, it's quite possible that economic growth will accelerate.

Once the market believes that the worst of the crisis of confidence has passed, the markets will perform similarly to 2009-10. The dilemma for portfolio managers is whether it is more productive to anticipate the inevitable recovery, not knowing when it will occur, or whether it makes more sense to wait until the turn. Europe could take some time to sort-out. Until then, we are emphasizing quality factors in our companies like dividend growth and free cash flow yields. In effect, we're acknowledging that while it's raining it makes sense to carry an umbrella. I'm confident that we will react in a timely manner when it seems like the sun is starting to come out.



Index Performance as of December 31, 2011	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth Index	-0.31	10.94	2.18	2.18	2.46
3000 Index	0.82	12.12	1.03	1.03	-0.01
3000 Value Index	1.98	13.33	-0.10	-0.10	-2.58
1000 Growth Index	-0.32	10.61	2.64	2.64	2.50
1000 Index	0.84	11.84	1.50	1.50	-0.02
1000 Value Index	2.02	13.11	0.39	0.39	-2.64
Mid-Cap Growth Index	-1.50	11.24	-1.65	-1.65	2.44
Mid-Cap Index	-0.12	12.31	-1.55	-1.55	1.41
Mid-Cap Value Index	1.25	13.37	-1.38	-1.38	0.04
2000 Growth Index	-0.22	14.99	-2.91	-2.91	2.09
2000 Index	0.66	15.47	-4.18	-4.18	0.15
2000 Value Index	1.57	15.97	-5.50	-5.50	-1.87
S&P 500					
Consumer Discretionary	1.28	12.58	6.13	6.13	2.02
Consumer Staples	2.76	10.26	13.99	13.99	7.61
Energy	-1.02	18.20	4.72	4.72	4.68
Financials	1.76	10.82	-17.06	-17.06	-16.90
Health Care	2.92	9.96	12.73	12.73	2.81
Industrials	1.17	16.52	-0.59	-0.59	0.50
Information Technology	-0.87	8.72	2.41	2.41	3.83
Materials	-2.11	15.39	-9.75	-9.75	1.76
Telecommunication Services	3.97	7.90	6.27	6.27	1.39
Utilities	3.37	8.28	19.91	19.91	3.71
Other U.S. Equity					
Dow Jones Industrial Avg	1.58	12.78	8.38	8.38	2.37
MSCI USA	0.95	11.73	1.99	1.99	-0.04
Wilshire 5000 (Full Cap)	0.84	12.43	1.02	1.02	0.42
International Equity - Broad Market					
MSCI EAFE	-0.94	3.38	-11.73	-11.73	-4.26
MSCI Emerging Markets	-1.20	4.45	-18.17	-18.17	2.70
MSCI Frontier Markets	-1.12	-1.92	-18.38	-18.38	NA
MSCI AC World	-0.17	7.30	-6.86	-6.86	-1.41
MSCI AC World ex USA	-1.10	3.77	-13.33	-13.33	-2.48
MSCI AC Asia ex Japan	0.59	3.30	-17.07	-17.07	2.87
International Equity - Country Region					
MSCI Brazil	-1.95	8.94	-21.59	-21.59	8.66
MSCI BRIC	-2.18	4.42	-22.67	-22.67	1.22
MSCI China	2.48	8.11	-18.24	-18.24	2.64
MSCI Europe	-1.53	5.45	-10.50	-10.50	-4.63
MSCI India	-6.00	-14.25	-37.17	-37.17	-1.15
MSCI Japan	0.84	-3.85	-14.19	-14.19	-6.43
MSCI EM Latin America	-1.56	8.81	-19.15	-19.15	6.84
MSCI Russia	-10.61	6.19	-19.30	-19.30	-8.40
Fixed Income					
BC Aggregate Bond	1.10	1.12	7.84	7.84	6.50
Merrill Lynch 3-month T-Bill	0.00	0.00	0.10	0.10	1.48
BC Government	0.89	0.84	9.02	9.02	6.56
BC Credit Bond	1.94	1.70	8.35	8.35	6.80
BC High Yield Corporate Bond	2.66	6.46	4.98	4.98	7.54
BC Muni Bond	1.90	2.12	10.70	10.70	5.22
BC TIPS	0.04	2.69	13.56	13.56	7.95
BofA ML Global Broad Market Ex USD	0.44	-0.30	4.59	4.59	6.54
BofA ML Global Broad Market	0.71	0.32	5.98	5.98	6.53
BofA ML Emerging Market Credit	1.85	7.15	6.19	6.19	8.58
Alternative Investments					
NAREIT Equity REIT Index	4.79	15.25	8.27	8.27	-1.43
DJ-UBS US Commodity Index	-3.75	0.35	-13.32	-13.32	-2.07
HFRI Equity Hedge	-0.66	2.86	-5.51	-5.51	1.91
HFRI Equity Market Neutral	1.24	2.20	1.97	1.97	1.94

