

Asset Allocation Update

The outsized growth in the fourth quarter Gross Domestic Product (GDP) came courtesy of a large inventory bounce and will likely not be repeated. That said, the supports to the growth cycle continue to firm with higher capital expenditures, stable but not stellar consumer spending growth and improving exports. The recovery appears on track for slow but sustainable economic growth in 2010, but headwinds to a stronger recovery remain in place. Real improvement in labor market trends awaits a job hiring phase to kick in, not just fewer job losses. At this point, businesses remain reluctant to add to payrolls and this will hold down income growth. High debt levels and continued deleveraging by consumers will weigh on spending, although we do expect consumption to advance slowly.

Housing continues to stabilize as inventory levels correct and housing starts find a bottom. Shadow inventories, high levels of unemployment and homeowners with underwater mortgages will likely present challenges to a quick housing recovery. Credit intermediation within the banking system, a critical support for economic growth going forward, does not yet appear to be improving. Recent data from the Fed indicates that overall bank loan growth is still contracting, as demand for credit remains weak and banks seem less willing to lend, with the exception of residential mortgages that can be packaged and sold to government agencies. With inflation expectations normalizing, a tepid demand environment and slack capacity in the economy, there is little evidence that suggests that inflation should be a near-term concern. Reduced inflation fears and the expected softer recovery will keep the Fed out of play and policy accommodative, even as they unwind extraordinary policy stimulus.

Following the strong run in riskier asset classes off of 2009 market lows, the committee had scaled back its overweight to small-cap equities in favor of a neutral tactical position. Small-cap names had been a clear beneficiary of the shift in investor sentiment back toward riskier assets following the flight to quality witnessed earlier last year. The group maintained its overweight to emerging markets stocks as it continued to expect strong growth in developing regions. Growth prospects for emerging markets in 2010 are projected

to perform much better relative to the United States or developed Europe. Emerging markets also weathered the financial crisis much better than the developed nations. Unlike in prior global crises, the foreign exchange markets, sovereign debt markets, emerging markets' banking sectors and emerging equity markets appeared much more resilient. The committee also favored a small overweight to large-cap names. Growth prospects for developed international markets do not differ much from those of U.S. large companies, and valuations for both large-cap domestic equities and developed international equities appear reasonable. Concerns over sovereign debt in Europe and the strength of the dollar have led us to view domestic equities favorably over developed international equities. As such, we have shifted from a neutral position to developed equities to an underweight position. Given our expectation that economic data will show continued improvement over the next few quarters, we have maintained a positive tilt toward equities overall, though the size and the speed of the rally prevents us from taking a larger overweight position.

Within fixed income, the committee increased its overweight in investment-grade debt and underweight securitized products. The Fed's quantitative and credit easing efforts via the \$1.4 trillion mortgage-purchase program have been a critical support for the mortgage-backed securities market, raising prices and lowering yields to historical extremes. As a result, this sector has seen strong outperformance in the recent period, something unlikely to be repeated going forward. As the government's mortgage-purchase program is scheduled to conclude in March, mortgage rates appear likely to rise. Thus, the group sees mortgage-backed securities as likely to underperform. Measures of investor cash balances remain high despite the low yields, but the committee believes that investors will be increasingly attracted to the higher returns available in corporate bonds. As a result, we are reallocating to a heavier overweight in investment-grade and a slight overweight in high-yield corporate bonds. A neutral, tactical position is favored in Treasury Inflation-Protected Securities (TIPS). Seeing minimal opportunity for Treasuries to outperform in the near term, the group maintained its underweight in the space.

With money market rates still quite low, the committee decided to maintain its underweight cash.

We are adding 2.5% of the portfolio to commodities. Underlying longer-term supply issues from decades of underinvestment in almost all commodity sectors combined with continued strong growth in a highly populated developing world underpin a very bullish picture for the asset class. Additionally, commodities continue to be a successful hedge against a decline in the U.S. dollar, and one of the few attractive alternatives in a world where central banks have set loose the printing presses. Commodities, in short, remain one of the few real or inflation-proof assets available to investors.

Regardless of the business cycle in the developed world, Asia, and particularly China, will continue to be at the center of the commodity demand story for some time. Resource-heavy investment remains a large percentage of GDP in Asia. India and China, as well as Southeast Asian countries such as Vietnam, will continue to deploy their trade surplus savings into making better roads, housing and living conditions for their large populations over the coming decades. Even as domestic consumption rises relative to investment in Asia, this greater regional wealth will necessarily translate into greater demand for a range of commodities — developing Asia will buy more automobiles (oil) and eat more varied and meat-rich diets (putting greater strains on limited global agriculture and livestock supplies).

Finally, it is worth noting that our longer-term goal is to migrate to “easy terrain,” an alternative approach to asset allocation that places less emphasis on maximizing returns and focuses more on balancing the trade-off between risk and reward. Within such an approach, about one third of our total risk budget is dedicated to inflation-protection instruments that include commodities, so we should continue to add even more to our current exposure level going forward.

Past performance is no guarantee of future results.

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