INtRODUCtION

The world’s economies certainly experienced their share of drama in 2010. Here in the United States, following several quarters of moderate growth, the recovery nearly stalled in mid-year as the unresolved European fiscal crisis collided with the ongoing housing mess and structural unemployment. Headlines regularly warned of a “double-dip” recession. Even amidst this turmoil, the National Bureau of Economic Research (NBER) released its official statement that the recession that began in December of 2007 had ended in June of 2009. This makes the 18-month recession the longest and deepest downturn for the U.S. economy since the Great Depression. Still, for many of us, it feels like the recession continues.

ECONOMIC OUtLOOK

On the positive side, the economy appears to be slowly emerging from its mid-year soft patch. Third quarter GDP was revised up to 2.5% following a 1.7% reading in the second quarter. Inventory building and growth in final sales accounted for most of the overall improvement. Unfortunately, weak income growth means real consumption growth is unlikely to accelerate substantially as households continue to struggle with debt levels and job worries. Recent rises in oil prices and agricultural products will also reduce spending power. While it is currently difficult to find many indications of meaningful economic acceleration, recent signs of a tax compromise could spur activity toward the top end of a 2.5% to 3% growth range in 2011.

The Federal Reserve (Fed) has kept the Fed Funds rate near 0% for two years now and the rate is projected to stay there through most of 2011. The Fed has stated that the current high unemployment and low inflation levels are not consistent with its dual mandates. To this extent Fed Chairman Ben Bernanke has announced another round of quantitative easing (QE2) with the purchase of a further $600 billion of Treasury securities. The program is designed to work through the same channels as conventional changes in short-term rates. Lower rates should encourage households to spend more and make capital investments more attractive for businesses. This should partially offset the effects of the ongoing deleveraging process that has yet to run its course.

Recently there has been some backlash against the Fed’s quantitative easing policies due to worries about possible inflationary effects. In fact, QE2 was partly designed to ease fears about deflation (not to raise inflation concerns). However, in the short run at least, inflation seems unlikely. The persistent high level of economic slack continues to put downward pressure

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on prices. In fact, the most recent Consumer Price Index (CPI) data have revealed further moderation in the core numbers. In October the 12-month change in the core index, which excluded food and energy, fell to a record low of 0.6% (since its 1959 inception). The aforementioned slack, as well as the continued weakness in housing and labor costs, argue for subdued inflation and signal that downward pressure on prices will prevail for now.

The persistent high level of unemployment in the United States is a very big concern, but the picture has slowly improved this year. Private payroll employment has grown every month so far in 2010 at an average rate of 110,000 jobs per month. However, labor market conditions have yet to improve enough to reduce the unemployment rate. Payroll employment needs to rise consistently above 200,000 per month to significantly lower the unemployment rate. (Chart 3) Annual Gross Domestic Product (GDP) growth of at least 3.5% (more than forecast) would be required to get to this level of hiring. Since GDP is not expected to reach this level, the unemployment rate will likely remain stubbornly above 9% over the next year.

The ongoing European fiscal problems are affecting exchange rates and borrowing costs around the world. Since the Greek bailout was unveiled in May, bond yields/spreads have risen in Portugal, Italy, Ireland, Greece and Spain (PIIGS). European Union policymakers want to assure that there are no sovereign defaults and that their banking systems won’t melt down. But in order to avoid this occurrence, enough money and/or credit from the European Central Bank, other governments and the International Monetary Fund (IMF) must be provided to bridge the budget and financing gaps. This is a developing situation, but it appears that policymakers are moving toward the difficult choice of providing stability through additional policy back-stops.

**FIXED INCOME OUTLOOK**

International events added volatility to the bond market throughout 2010. The year began with credit problems in Greece and is ending with troubles in Ireland. Domestically, the bond market was trying to decide whether to be more worried about deflation or inflation. Declining rates for most of the year reflected a bias toward deflation, but lower rates were also aided by the Federal Reserve’s actions. At the November Federal Open Market Committee (FOMC) meeting, the Fed’s statement announcing further quantitative easing initially kept downward pressure on interest rates. But as the QE’s downside sank in, bond market vigilantes pushed rates higher.

The Treasury yield curve began the year with a steep slope and stayed that way throughout the year. Investors willing to venture out into the intermediate area (2 through 10 years) of the yield curve were rewarded, while those in money market funds suffered with historically low yields. (Chart 4) The yield give-up for staying in shorter maturities (versus intermediate and long maturities) has rarely been greater than it is now.

As we come to the end of the year, the yield difference between two- and 30-year Treasuries reached 3.63%. Interest rates declined across the yield curve during the year, but to a lesser extent for 30-year Treasuries. In November, the two-year Treasury yield hit a record low of 0.33% in reaction to economic growth losing its momentum. Concern about inflation is low for the short-run but still remains a worry over the long-run.

The combination of low Treasury rates and a positive credit climate contributed to the rise in corporate debt issuance in the second
half of the year. Near perfect conditions allowed issuers to tap the market at the lowest coupon rates seen since records have been kept. For example, both Walmart and Coca-Cola issued three-year debt at a 0.75% yield.

The gap between yields of investment-grade corporate bonds and Treasuries represents the extra premium investors demand due to the greater risk associated with corporate bonds. This risk premium (i.e., spread level) gradually rose in the first half of the year as credit problems developed in Greece. Spread levels started the year at 190 basis points and reached a peak of 213 basis points in June, according to Merrill Lynch’s U.S. Corporate Master Index. The second half of the year found spreads slowly tightening, recently reaching 182 basis points at the end of November. (Chart 5) Additional tightening would have likely occurred if the credit problems in Ireland had not flared up.

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned 7.70% for the first 11 months of 2010. Tighter spreads and lower interest rates helped produce strong positive results across the various fixed income sectors. Corporate bond spreads were helped by declining default rates as the financial health of companies improved. The high yield and emerging market bond sectors finished on top with agency debentures coming in as the laggard. (Chart 6)

Emerging market bond funds are on pace for a record level of inflows for 2010. Growing economies and improving credit quality in many of the emerging market countries raised investor interest. Recently, as credit problems worsened in Ireland, inflows slowed and some investors started taking capital gains.

The Barclays Municipal Bond Index was up 4.40% year-to-date through the end of November. Lower rated A/BBB segments of the municipal bond market have performed significantly better than the AAA/AA segments. An increase in municipal bond supply during the past few months (both taxable and tax-exempt), along with a constant barrage of negative press surrounding municipal issuers, has created an opportunity to buy high quality tax-exempt municipal bonds at virtually the same yields as Treasury bonds.

As we approach 2011, we believe the economy is still moving forward on the road to recovery. The threat of higher interest rates will likely grow as we progress through the new year. However, economic growth is likely to remain subpar relative to past recoveries, limiting inflation concerns and the threat of a large jump in interest rates. If rates rise, there are several factors that could mitigate the negative impact on performance – tightening spreads and a supply/demand imbalance. Spreads are still wider than their historic averages and are expected to improve if the economy continues to grow. Bond prices are also anticipated to be positively impacted by the lack of supply in other fixed income asset classes, such as commercial properties and non-government mortgages.

The European debt crisis continues to unfold. Sovereign default risk concerns are growing for all countries involved in the PIIGS group. U.S. Treasuries could be the beneficiary of a flight to quality if the situation worsens. Spreads on emerging market debt could widen if conditions significantly deteriorate in Europe.

High cash levels on corporate balance sheets and historically low corporate bond yields make the current environment ripe for shareholder value enhancing strategies, such as share buybacks, dividends and mergers and acquisitions activity to the detriment of bond holders.

### CHART 3
**EMPLOYMENT**
Job growth needs to be higher than a 200,000 per month pace in order to lower the unemployment rate.
- Monthly Increase (Left Axis)
- 3-Month Change (Right Axis)

### CHART 4
**HISTORICAL YIELD CURVE**
(12/31/09 - 11/30/10)
Interest rates declined across the yield curve and the curve’s slope remains historically steep.
- 12/31/09
- 11/30/10

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With various factors pulling the market in different directions, we are expecting Treasury yields to trade in a range for the short-run. The Fed's actions to improve the economy will likely err on the side of inflation, leading us to anticipate rising interest rates in the long-run. We are maintaining our slightly shorter duration/maturity position relative to the benchmark as we expect the threat of higher rates to be more likely than declining rates.

Another issue adding uncertainty to the market is the future of the Build America Bonds program (BAB). The BAB program allows state and local governments to issue taxable bonds and receive a 35% federal subsidy. The program is scheduled to expire at the end of 2010. However, due to the program's success at reducing funding costs, there has been a push to extend the program (with a reduction in the subsidy to 28%). Liquidity would suffer for these bonds if the program expires. Some of this risk is reflected in the bonds' prices currently, but some additional spread widening is possible if it is not extended.

In the coming year, the impact of QE2 and stronger economic growth are powerful forces that will likely offset the effect of the European debt crisis. Value is expected to be found with investment-grade corporates. Opportunities may develop with taxable municipal bonds and emerging market debt if investors overreact to the uncertainty associated with those sectors. Tax-exempt municipal bond yields still look attractive relative to Treasury yields and could become more attractive if state budget problems expand.

EQUITY OUTLOOK

In 2010 we expected the Dow Jones Industrial Average would likely trade in a plus 10% to minus 10% range for most of the year. As can be seen in (Chart 7), this thesis proved correct. Upside was limited by stretched valuation ratios that could only be cured by improving earnings. A year ago we had projected operating earnings for the S&P 500 to increase 20% to 25% in 2010. Corporate America has surpassed our expectations with expected earnings gains of 45%. That has driven the operating price earnings ratio (P/E) from 19.6X to 14.2X based on the November close and estimated earnings for 2010. P/E levels at 14X were last experienced in the late 1980s. Consensus for 2011 earnings is a gain of 13%, driving valuation levels even lower. With inflation very low, we believe valuations are at some of the most attractive levels in 50 years.

Valuation levels are low because investors are worried about a long list of problems. Topping the list is how the European sovereign debt crisis will be solved. Next are the debt problems of the United States, along with several states that have their own debt problems. Also, tensions between North and South Korea, a possible slowdown in China, rising commodity prices, high unemployment, and political uncertainty/gridlock all point to a rather dismal perceived outlook for stocks. These concerns are weighing on consumer confidence, which remains at historically low levels.

Investors continue to sell equity mutual funds as they shift their assets to bond mutual funds.

Before one gets too negative on
stocks, let’s review how corporate America has survived the turmoil of the last three years. Companies cut costs quickly in 2009 and have dramatically improved productivity levels and profit margins. While growth in Europe and the United States remains slow, many of the emerging market countries have picked up the slack with strong growth. Stronger commodity prices actually help profits for a majority of the companies in the S&P 500. Additionally, much of the earnings of S&P 500 companies are derived from outside the United States. Corporations have a record amount of cash on their balance sheets and have been able to refinance their debt at extremely attractive rates. As we stated above, corporate profits are only 5% below the record highs in 2006, so maybe things are not as bad as we think.

While the public remains skeptical of equity investments after the plunge in 2008 and 2009 and the flash crash in May of 2010, just the dividend return alone looks very attractive when compared to bond yields. It has been over 50 years since the after-tax return for the S&P 500 dividend yield has been the same as the after-tax 10-Year Treasury yield. We believe the equity market will break out to the upside in 2011 from the trading range we have been in so far in 2010. The long list of problems will not go away, but some incremental improvements should send stock prices higher.

A trend we expect to continue in 2011 is large companies buying mid- and small-cap companies as a way to expand their market share. Mid-cap stocks were the leaders in 2010 and we believe that trend will carry forward. (Chart 8) We are also concentrating equity portfolios on U.S. companies and underweighting European and Japanese large-cap stocks. We continue to recommend exposure to small caps in the international developed markets along with exposure to emerging markets.

INTERNATIONAL OUTLOOK
The picture in most international developed countries is similar to that of the United States. Growth is positive, but still anemic for a recovery stage. The economies that led the stock market turmoil earlier in the year (Portugal, Ireland, Italy, Greece and Spain) are still largely on shaky ground. Peripheral European yields are rising and the news is still packed with stories regarding bailouts, tax increases and austerity measures as governments attempt to steady unstable economies. Some are questioning the future of the euro as a currency, and the future effects of the Basel III bank reforms on credit availability will be closely watched.

Some European countries have fared better. According to the most recent survey, business sentiment in Germany has risen sharply. Private sector confidence has strengthened in France and employment is expanding there. The United Kingdom posted stronger-than-expected growth in the third quarter, and retail sales grew in October for the first time in three months. With solid real GDP growth in the third quarter and inflation above target rates, the Bank of England has thus far declined to follow the United States with more quantitative easing.

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In Japan growth has weakened along with production and retail sales. Unemployment remains high by Japanese standards. Japanese core CPI is negative despite government voucher programs that have propped up demand. Australia is relatively healthy and has tightened monetary policy. In Canada, retail sales growth has been solid, but manufacturing sales have been weak.

Overall, the recovery in the developed world is fragile and many economists are still calling for quantitative easing in the wake of near-zero interest rates and tenuous growth.

In sharp contrast, emerging markets are enjoying robust growth. China’s economy is characterized by relatively strong growth in the high-single-digits. Inflation there has been modest but could be picking up, and the renminbi (official currency of the People’s Republic of China) is poised for further appreciation. India also is enjoying upper-single-digit growth, with strong trends in its industrial, service and construction sectors. Inflation in India has been high, particularly in food.

With abundant natural resources, Brazil has been expanding at a mid-single-digit pace and continues to benefit from accelerating demand for commodities from countries like China and India. Russia is experiencing growth of about 4%, below that of other emerging market giants, but well above developed world counterparts. Inflation there is high.

After the stock market sell-off in the second quarter, most major international stock markets have experienced a rebound, and the markets are now poised to finish the year in positive territory barring any unforeseen setbacks. As of November 30, the MSCI All Country World Index ex-US year-to-date return stood at 4.29%, underperforming the U.S. markets. Emerging markets have easily outperformed developed markets (12.07% versus 2.04%). (Chart 9)

Frontier markets are up more than 18%.

Individual country returns have varied widely, with some emerging/frontier markets such as Argentina and Sri Lanka posting gains north of 65%, while markets in Portugal, Spain, Ireland, Italy and particularly Greece have experienced sizable negative returns, not surprisingly. The BRIC countries (Brazil, Russia, India and China) have witnessed a fairly wide dispersion in returns, with India’s market up more than 13%, Russia up more than 8%, China close behind at almost 7%, and Brazil trailing at 1.36%.

International bonds in developed markets, up about 3.60%, also have trailed the U.S. market, while emerging market bonds, up about 13.42%, have outperformed.

We continue to emphasize emerging markets within our international allocations, both in equities and fixed income. Growth in these markets is far outpacing that of developed countries, and balance sheets are generally stronger. Over the years, liquidity has improved, and there also is the opportunity to capture the positive effects of potential currency appreciation, particularly in countries like China.

ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments typically include investment strategies in the main categories of hedge funds, real estate, private equity, and commodities/natural resources/real assets. From a portfolio diversification standpoint, alternative investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds. By introducing investments that behave differently from the rest of the portfolio, they can reduce portfolio risk (volatility) and potentially enhance long-term returns.

Hedge Funds

After a strong 2009, hedge fund returns were more muted in 2010. The HFRI Fund of Funds Composite Index year-to-date return was 3.03% as of November 30, 2010. Quantitative directional, event-driven, distressed and fixed income strategies posted high-single-digit to low-double-digit returns. Market-neutral and short-bias strategies posted flat to negative returns and lagged most hedge fund and long-only stock and bond strategies for 2010.

We believe it makes sense to focus on conservative, multi-manager funds that employ little to no leverage. Several hedge fund strategies are offered in a mutual fund structure that offers daily liquidity, manager transparency,
low minimums and an attractive fee structure. Conservative funds may not capture as much return as a traditional equity investment in a rapidly rising market, but they can provide a cushion in a declining market environment.

**Commodities**

Commodities are an investment strategy for those seeking real return. Real return strategies focus on ways to preserve and enhance purchasing power and provide portfolio diversification from traditional stock and bond investments. Historically, commodities are positively correlated to inflation and changes in inflation.

While the Federal Reserve is concerned about the lack of inflation in the U.S. economy, investors debate on when inflation will return. The DJ-UBS Commodity Index was up 5.92% year-to-date as of November 30, 2010. All commodities, except for natural gas, were up for the year. Supply shocks and adverse weather conditions helped drive up the price of agricultural products. While commodity indices have recovered strongly from their lows in 2009, they are still off their peak of July 2008. (Chart 10)

**Revised oil demand forecasts** have had an upward bias yet oil prices have risen 7.7% year-to-date as of November 30, 2010. Oil prices may not fully reflect the strength in demand and we expect oil prices to trade in the $80 to $100/barrel range over the next year. Asia Pacific has overtaken North America as the biggest oil consumer and is expected to show increased oil demand going forward.

Gold attracted strong investment flows throughout the year. Gold benefitted from the lack of confidence in the U.S. economy and the weak dollar. Furthermore, the opportunity cost of holding gold, a non-income producing asset, is low amidst the current interest rate environment.

The outlook for commodity demand is positive. Commodity production and distribution capacity has suffered from years of under-investment, resulting in a supply constraint that may last for some time. Emerging economies such as China and India are experiencing improvements in their standards of living. Increased demand for durable goods and better food is expected, which will support raw material and commodity prices.

**Real Estate/REITs**

While the residential real estate recovery has stalled, and recent moves to halt foreclosures only delay the recovery, the REIT market is a different story. The MSCI US REIT Index returned 22.8% year-to-date as of November 30, 2010. REITs’ positive performance in 2010 was driven by continued improvement in credit markets, low interest rates and a low supply of new real estate properties.

Investors flooded REIT funds in 2010 in their search for income yield. Current REIT dividend yields are now 3.5% and are well supported by underlying free cash flow yields of 5.4%. Current payout ratios are low by historical standards, providing near-term dividend growth in the high-single-digit to low-double-digit range. REITs also offer a potential hedge against inflation, although the threat of such is not close at hand.

**Private market pricing** for real estate is competitive in the top institutional markets for all property types. Open-end real estate funds have an estimated $6 billion of new capital waiting to be invested. Publicly traded REITs appear to have discounted much of the improvement in the real estate markets and look expensive on various comparison measures, including the S&P 500 earnings yield. Furthermore, real estate managers face a wall of real estate debt that needs to be refinanced over the next five years.

**Private Equity**

Long-term investors who can tolerate the lack of liquidity may be well served to allocate to the private equity asset class. The Cambridge Associates U.S. Private Equity Index has outperformed the S&P 500 Total Return Index over three-, five- and ten-year periods by a range of 8.9% to 9.9% annualized through June 2010. This is the premium earned by patient investors in this illiquid investment sector.

While industry transaction volume is down from the 2006-2008 levels, deal flow and investment activity has been robust in 2010 and new investments are positioned to

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perform well. Private equity managers are facing less competition for deals and are able to invest in strong companies at reasonable valuations. Historically, private funds raised during recessionary periods have yielded higher returns than those raised during strong economic times.

Private equity managers are actively investing in some of the highest growth sectors of the market today, including energy, technology and healthcare. The globalization of capitalistic economies is providing a growing opportunity for private equity outside the United States and Europe.

CONCLUSION

Worries continue to weigh on investors, and they are many: the European debt crisis, the burgeoning federal deficit, state and local fiscal problems, tensions in North and South Korea, a slowdown in China, high unemployment, and political gridlock, just to name a few. Despite this, we have enjoyed positive double-digit-returns in stocks and high-single-digit-returns in bonds in 2010, and the economy does appear to be slowly healing. Although it is likely to remain anemic for some time, growth should be supported by continued low interest rates as the Fed works to offset stubbornly high unemployment, a depressed housing market, and a deleveraging consumer. Robust corporate profits and strong exports have also helped support very modest economic growth. Inflation is not a concern in the near-term due to the high level of economic slack and weakness in housing and labor costs.

Financial markets have been volatile this year as they have reacted to the headlines abroad and at home. In the coming year, we expect there will be value in investment-grade corporate bonds. Investor overreaction may create opportunities in taxable municipal bonds and emerging market debt as well. Tax-exempt municipal bonds remain attractive relative to Treasuries. We expect stocks to break out of the up 10% and down 10% range they have traded in all year, supported by low valuations and improving corporate earnings. We like mid-cap stocks as beneficiaries of increased merger and acquisition activity, and recommend exposure to international small-cap and emerging market stocks. We favor U.S companies over European and Japanese large companies. As a means to reduce volatility and hedge against inflation, we recommend a strategic position in alternative investments, including conservative hedge funds, commodities, real estate and gold. Long-term investors who can tolerate the lack of liquidity may be well served to allocate to the private equity asset class.