



City of Cincinnati Retirement System Investment Committee

**February 4, 2010 12:00 P.M.
Centennial II – Meeting Room A**

AGENDA

Call to Order

Lunch

Approval of Minutes

- 🚩 December 3, 2009

New Business

- 🚩 Marquette Associates
Brett Christenson, Managing Director, Gregory Leonberger, Director of Research
 - December Flash Report
 - Shenkman Capital Management: Four Points Product
 - Review of Private Equity Investment Strategy
 - Discuss the limits on funds managed by one manager
 - Inflation discussion
- 🚩 Paula Tilsley, CRS Executive Director
 - Funding Ratio Report
 - ABS Offshore SPC Global Segregated Portfolio: Fee Structure
- 🚩 Jack Walsh, Chair
 - Governance Schedule – Investment Committee Assignments

Adjournment

Next Meeting: March 4, 2010 - Centennial II, HR – Room A



City Of Cincinnati Retirement System Investment Committee

Minutes

February 4, 2010 / 12:00 P.M.
Centennial II Meeting Room A

The meeting was called to order: 12:00 P.M.

Present:

Jack Walsh - Chair
David Rager – Vice Chair
Donald Beets
Michael Fehn
Brian Pickering
Michael Rachford
James Robinson
Bryan Schmitt

Staff Present:

Paula Tilsley
Ron Wilson
Cheryl Volk

Minutes

The Investment Committee minutes from December 3, 2009 were submitted for approval. B. Pickering made a motion to accept the minutes. M. Rachford seconded the motion and the motion passed. Minutes were approved.

The Cincinnati Retirement System (CRS) Investment Consultant, Marquette Associates

- ✚ Brett Christenson, Managing Director provided the following reports:
- 4th Quarter Report for 2009: End of Quarter Portfolio Market Value: \$1.98 billion. Year to date Investment Performance: +20.3%, underperforming the policy Benchmark: +21.9%.
 - U.S. Economy
 - Fixed Income Markets
 - U.S. Equity Markets
 - Global Economy
 - International Equity Markets
 - Hedge Fund Markets
 - Real Estate Markets
 - Infrastructure
 - OPUS Capital Management Site Visit
B. Christenson reported a positive site visit with OPUS. The visit included a review of their disaster plan and compliance with Global Investment Performance Standards (GIPS).

- PIMCO
Due to improved performance, B. Christenson recommended PIMCO be Removed from Alert Status

Committee Action

B. Pickering made a motion to remove PIMCO from Alert Status. J. Robinson seconded the motion and the motion passed.

✚ Asset Allocation: B. Christenson recommended for consideration:

- Cancel the prior commitment of \$10 million to Private Equity Fund of Fund Manager, Fort Washington Capital Partners, Fund VII.

Committee Action

B. Schmitt made a motion to cancel the commitment of \$10 million to Private Equity Fund of Fund Manager, Fort Washington Capital Partners, Fund VII. M. Fehn seconded the motion and the motion passed with one No vote from Jack Walsh.

- Allocate \$10 million from International Equity Manager, Harding Loevner to Fixed Income Manager PIMCO.

Committee Action

M. Rachford made a motion to allocate \$10 million from International Equity Manager, Harding Loevner to Fixed Income Manager PIMCO. B. Pickering seconded the motion and the motion passed.

- Consider increasing asset allocation to real estate in the first half of year 2010.

✚ Gregory Leonberger, Director of Research, Marquette Associates provided the following report on Investing in Inflationary Environments:

- Definition of Inflation
- Inflation's impact
- Inflation protection
- Treasury Inflation Protection Securities (TIPS) overview.
- Commodities
- Infrastructure
- Real Estate

Meeting was adjourned at 1:50 P.M.

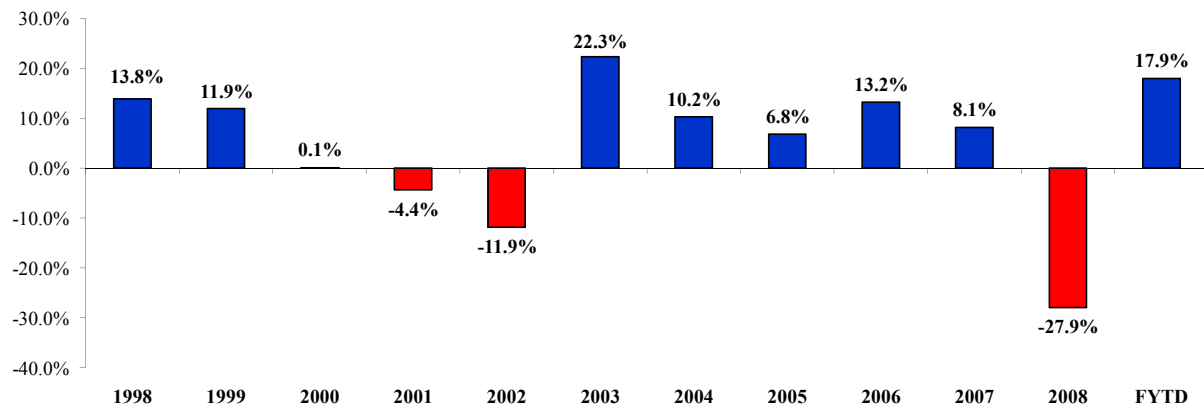
City of Cincinnati Retirement System

**Investment Report
November 30, 2009**



Market Values November 30, 2009				Annualized Performance November 30, 2009								
Asset Class	Market Values	Allocation	Target	1 Mon.	YTD	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr	7 Yr	10 Yr
Total Fixed Income	\$375,719,684	19.2%	17.0%	0.7%	21.2%	27.0%	7.2%	7.3%	6.5%	5.9%	6.0%	7.0%
Total U.S. Equity	\$633,989,422	32.5%	29.5%	5.2%	23.3%	26.5%	-11.7%	-3.3%	-0.6%	2.2%	6.7%	1.4%
Total International Equity	\$420,951,076	21.6%	21.0%	2.7%	33.0%	41.9%	-10.3%	-0.3%	4.2%	8.4%	11.1%	2.5%
Total Real Estate ¹	\$107,339,418	5.5%	7.5%	-0.2%	-30.5%	-35.9%	-19.6%	---	---	---	---	---
Total Long/Short Equity	\$277,397,818	14.2%	15.0%	1.4%	12.8%	12.4%	---	---	---	---	---	---
Total Private Equity ²	\$84,265,862	4.3%	5.0%	See Page 5	---	---	---	---	---	---	---	---
Total Infrastructure	\$47,185,602	2.4%	5.0%	See Page 5	---	---	---	---	---	---	---	---
Total Cash Equivalents	\$5,769,584	0.3%		---	---	---	---	---	---	---	---	---
TOTAL PORTFOLIO	\$1,952,618,466	100.0%	100.0%	2.6%	17.9%	20.4%	-7.9%	-0.9%	1.3%	3.4%	6.6%	3.2%

Fiscal Year Returns



¹Market Values as of 9/30/09 plus J.P. Morgan.

²Market Values of 09/30/09 including 2009 capital calls and distributions.

Market Values

November 30, 2009

Asset Class	Investment Manager	Market Values	Allocation	Target
Core Fixed Income	Blackrock	\$146,798,589	7.5%	6.5%
Core Fixed Income	PIMCO	\$124,860,559	6.4%	6.5%
High Yield Fixed Income	Shenkman	<u>\$104,060,536</u>	<u>5.3%</u>	<u>4.0%</u>
Total Fixed Income		\$375,719,684	19.2%	17.0%
All-Cap Core Equity	Allegiant	\$135,019,646	6.9%	6.5%
All-Cap Core Equity	PanAgora	\$135,669,350	6.9%	6.5%
All-Cap Value Equity	Bartlett	\$47,640,875	2.4%	2.0%
Large-Cap Value Equity	Rhumblin	\$63,159,812	3.2%	3.0%
Large-Cap Growth Equity	Montag & Caldwell	\$61,342,782	3.1%	1.5%
Mid-Cap Growth Equity	Rhumblin	\$51,788,043	2.7%	2.5%
Mid-Cap Growth Equity	Turner	\$44,988,184	2.3%	2.5%
Small-Cap Value Equity	Opus	\$44,613,534	2.3%	2.5%
Small-Cap Value Equity	WCM	\$44,396,953	2.3%	2.5%
Cash Equitization	Clifton Group	<u>\$5,370,243</u>	<u>0.3%</u>	<u>0.0%</u>
Total U.S. Equity		\$633,989,422	32.5%	29.5%
International Value	Mondrian	\$148,736,459	7.6%	7.5%
International Core	Harding Loevner	\$153,277,821	7.8%	7.5%
International Small Value	DFA	\$57,919,338	3.0%	3.0%
Emerging Markets	Mondrian - EM	<u>\$61,017,458</u>	<u>3.1%</u>	<u>3.0%</u>
Total International Equity		\$420,951,076	21.6%	21.0%
Real Estate Core	J.P. Morgan SPF	\$39,655,153	2.0%	2.5%
Real Estate Core	Morgan Stanley P.P.	\$42,969,907	2.2%	2.5%
Real Estate Value-Added	PRISA III	\$9,243,990	0.5%	0.9%
Real Estate Value-Added	Principal Enhanced	\$11,435,999	0.6%	0.8%
Real Estate - Non U.S.	Mesirow/Courtland I	<u>\$4,034,369</u>	<u>0.2%</u>	<u>0.8%</u>
Total Real Estate		\$107,339,418	5.5%	7.5%
Long/Short Equity	ABS Global	\$138,553,202	7.1%	7.5%
Long/Short Equity	Common Sense	<u>\$138,844,616</u>	<u>7.1%</u>	<u>7.5%</u>
Total Long/Short Equity		\$277,397,818	14.2%	15.0%
Private Equity Venture	Blue Chip II	\$1,097,809	0.1%	---
Private Equity Venture	Blue Chip III	\$1,217,930	0.1%	---
Private Equity Venture	Blue Chip IV	\$16,542,408	0.8%	---
Private Equity FoFs Specialized	Fort Washington Fund V	\$15,525,955	0.8%	---
Private Equity FoFs Specialized	Fort Washington Fund VI	\$6,013,438	0.3%	---
Private Equity Buy-Out	Piper Jaffray III - LBO	\$13,199,395	0.7%	---
Private Equity Venture	Piper Jaffray III - VC	\$6,458,724	0.3%	---
Private Equity Buy-Out	Piper Jaffray IV - LBO	\$1,917,517	0.1%	---
Private Equity Venture	Piper Jaffray IV - VC	\$7,247,568	0.4%	---
Private Equity FoFs Specialized	Portfolio Advisors IV - Special Sit	\$11,561,001	0.6%	---
Private Equity FoFs Specialized	Portfolio Advisors V - Special Sit	<u>\$3,484,117</u>	<u>0.2%</u>	---
Total Private Equity		\$84,265,862	4.3%	5.0%
Infrastructure	Alinda II	\$13,973,964	0.7%	2.5%
Infrastructure	Macquarie II	<u>\$33,211,638</u>	<u>1.7%</u>	<u>2.5%</u>
Total Infrastructure		\$47,185,602	2.4%	5.0%
Cash Short-Term	Transition	\$0	0.0%	---
Cash Short-Term	Cash	\$2,439,886	0.1%	---
Cash Short-Term	Cash - Securities Lending	<u>\$3,329,698</u>	<u>0.2%</u>	---
Total Cash Equivalents		\$5,769,584	0.3%	
TOTAL PORTFOLIO		<u>\$1,952,618,466</u>	<u>100.0%</u>	<u>100.0%</u>

SHENKMAN CAPITAL MANAGEMENT, INC.

Gross Returns by Strategy

	3Q	YTD	1-Year	2-Year	3-Year	4-Year	5-Year	7-Year	10-Year
Shenkman High Yield Bond Composite ¹	8.72%	26.77%	13.65%	4.69%	5.67%	5.84%	5.80%	7.68%	6.75%
BofA Merrill Lynch High Yield Master II Index (H0A0) ²	14.82%	48.54%	22.36%	3.96%	5.21%	5.89%	6.05%	10.00%	6.04%
Shenkman Bank Loan Composite ³	4.42%	26.53%	6.87%	0.47%	1.85%	2.82%	3.21%	3.64%	3.67%
S&P LSTA Leveraged Loan Index ⁴	10.53%	46.11%	12.59%	1.71%	2.50%	3.37%	3.74%	4.82%	4.49%
Shenkman Convertible Composite ⁵	12.87%	30.75%	12.29%	4.01%	6.02%	6.56%	7.66%	---	---
BofA Merrill Lynch All Convertibles ex. Mandatory (V0A0) ⁶	15.90%	39.43%	13.49%	-4.87%	0.69%	2.45%	3.05%	---	---
Fenwick Recovery Master Fund	4.96%	44.87%	---	---	---	---	---	---	---
HFRI Distressed/Restructuring Index ⁷	10.45%	21.63%	---	---	---	---	---	---	---

**Periods over one year show annualized performance*

Disclaimers

- 1) The Shenkman Capital High Yield Bond Composite consists of comparable high yield bond accounts that employ the quadrant investment style and represents a substantial portion of the total high yield bond assets under Shenkman Capital's management (95% to 97% for 1986 to 1989; 98% to 99% for 1990 to 1997; 78% for 1998; 66% for 1999; 77% for 2000; 87% for 2001; 83% for 2002; 90% for 2003; 87% for 2004; 81% for 2005; 88% for 2006; 75% for 2007; 85% for 2008, and 86% through September), and excludes multi-sector and structured funds, and non-discretionary accounts. The performance results include reinvestment of dividends and other income and reflect all investment expenses, but are before a deduction of advisory fees, which vary depending on size and type of account and are described in Shenkman Capital's Form ADV, Part II. Prospective clients should consider the effect of advisory fees and any other expenses they may incur in connection with the account (i.e., custodian fee) on performance results. For example, a \$10 million account that incurs a quarterly advisory fee of 0.25% (i.e. 1.0% per annum) and has a gross performance of 11.5% per year over a 5 year period would have net performance of 10.4% per year after deducting the advisory fee. Performance information is for illustration purposes only and is not indicative of future results. Performance from 1993 through 2008 has been audited by Shenkman Capital's independent public accountants, a copy of which is available upon request.
- 2) The BofA High Yield Master II Index (H0A0) is unmanaged and is not available for direct investment.
- 3) The Shenkman Capital Bank Loan Composite consists of comparable bank loan accounts that do not employ leverage and represents a substantial portion of the bank loan accounts managed by Shenkman Capital for the applicable period (100% for 1998 – 2007 and 100% on December 31, 2008 and excludes structured funds and total rate of return swap accounts. Performance results include reinvestment of interest and other income and reflect all investment expenses, but are before a deduction of advisory fees, which vary depending on size and type of account and are described in Shenkman Capital's Form ADV, Part II. Prospective clients should consider the effect of advisory fees and any other expenses they may incur in connection with the account (i.e., custodian fee) on performance results. For example, a \$10 million account that incurs a quarterly advisory fee of 0.1875% (i.e., 0.75% per annum) and has gross performance of 7% per year over a 5-year period would have net performance of 6.20% per year after deducting the advisory fee. Performance results are for illustration purposes only and do not reflect the returns of any one account. Performance information is unaudited.
- 4) The S&P LSTA Leveraged Loan Index is unmanaged and is not available for direct investment.
- 5) The Shenkman Capital Convertible Composite consists of all the convertible securities held in discretionary accounts that are managed according to the firm's high yield bond strategy. For the period prior to January 1, 2005, 100% of the assets contained in the Shenkman Capital Convertible Composite were carved out of portfolios managed according to the firm's high yield bond strategy (the "Carve-out Accounts"). These returns for the Carve-out Accounts include a 2% cash allocation. The percentage of the composite that is composed of Carve-out Accounts for other periods is available upon request. The performance results include the reinvestment of dividends and other income and reflect all investment expenses, but are before a deduction of advisory fees, which vary depending on size and type of account and are described in Shenkman Capital's Form ADV, Part II. Prospective clients should consider the effect of advisory fees and any other expenses they may incur in connection with the account (i.e., custodian fee) on performance results. For example, a \$10 million account that incurs a quarterly advisory fee of 0.19% (i.e., 0.75% per annum) and has a gross performance of 10.0% per year over a 5 year period would have net performance of 9.20% per year after deducting the advisory fee. Performance information is for illustration purposes only and is not indicative of future results. Performance results do not reflect the performance of any one account
- 6) The BofA Merrill Lynch All Convertibles ex. Mandatory Index (V0A0) is unmanaged and is not available for direct investment.
- 7) The HFRI Distressed/Restructuring Index is unmanaged and is not available for direct investment.

Past performance is no guarantee of future results.

Investing in Inflationary Environments

What is Inflation?

- Decrease in value of money measured by rise in general price levels (indicated by Consumer Price Index)
- Increase in price makes money worth less
- Long-term inflation risk is a concern regardless of near term effect
 - ❖ Significant concerns when actual inflation is much greater than expected inflation, or when the inflation is unexpected

Why May Inflation Occur?

- Increase in the money supply
 - This is major concern at the present time
- Decrease of slack in the economy
 - Unused portion of the economy's productive capacity
 - E.g. underutilized industrial space, unused planes/trains
- High commodity prices
- Low unemployment

- Consumer Price Index rose 1.8% in past 12 months (December 2009)
 - Excluding volatile food and energy prices, inflation is slowing
 - Consumer prices increased 0.1% from November to December
- High levels of slack in the economy
 - 56% hotel occupancy rate (July 2009), lowest since 1987
 - 2,535 aircrafts worldwide in storage (July 2009) – 14.2% of the world fleet
 - One-third of freight car fleet in storage
 - 18.7 million homes vacant in 2Q 2009

Why Have We Avoided Inflation?

- Banks avoided lending billions of dollars injected by the Fed
 - Loans and leases on bank balance sheets down 5%
- High levels of unemployment means less power for workers to demand high wages
 - 10% unemployment (December 2009)
 - Private sector's cost of wages/benefits up 1.5% in 2Q 2009 compared to 3.5% over the decade

Pros

- In moderation, is a sign of healthy economy
- Moderate inflation can provide pricing power to market leaders
- Equity markets have correlated positively to moderate inflationary environments

Cons

- Reduces real rate of return
- Reduces purchasing power for individuals on fixed incomes (an increasing portion of the U.S. economy)
- More volatility causing reduced/delayed investment

Inflation Protection – A Few Options

- TIPS
- Commodities
- Infrastructure
- Real Estate

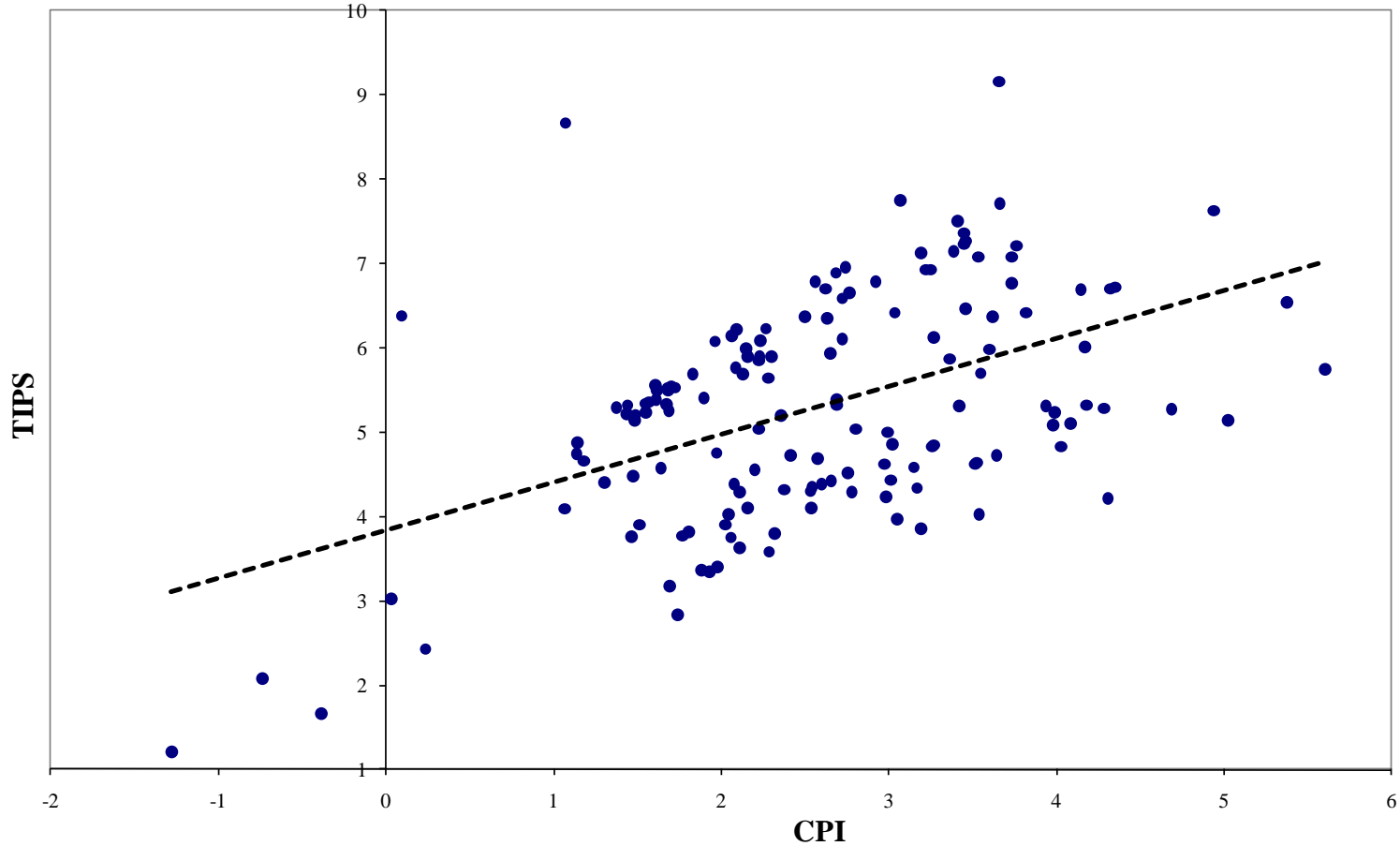
What are TIPS?

- Treasury bonds that protect against inflation risk
- TIPS pay a guaranteed inflation-adjusted (real) return
- Value of TIPS determined by Consumer Price Index (urban, non-seasonally adjusted)
- Principal adjusted for inflation at time of coupon payment
 - Coupon paid based on the new inflation-adjusted principal

- Assume initially,
 - TIPS bond purchase price is \$1000
 - CPI is 100
 - Coupon rate is 3%

- In six months,
 - CPI is 101 (2% annual inflation rate)
 - Principal adjustment: $101/100 * \$1000 = \1010
 - Adjust coupon payment: $3\% * 6/12 * \$1010 = \15.15

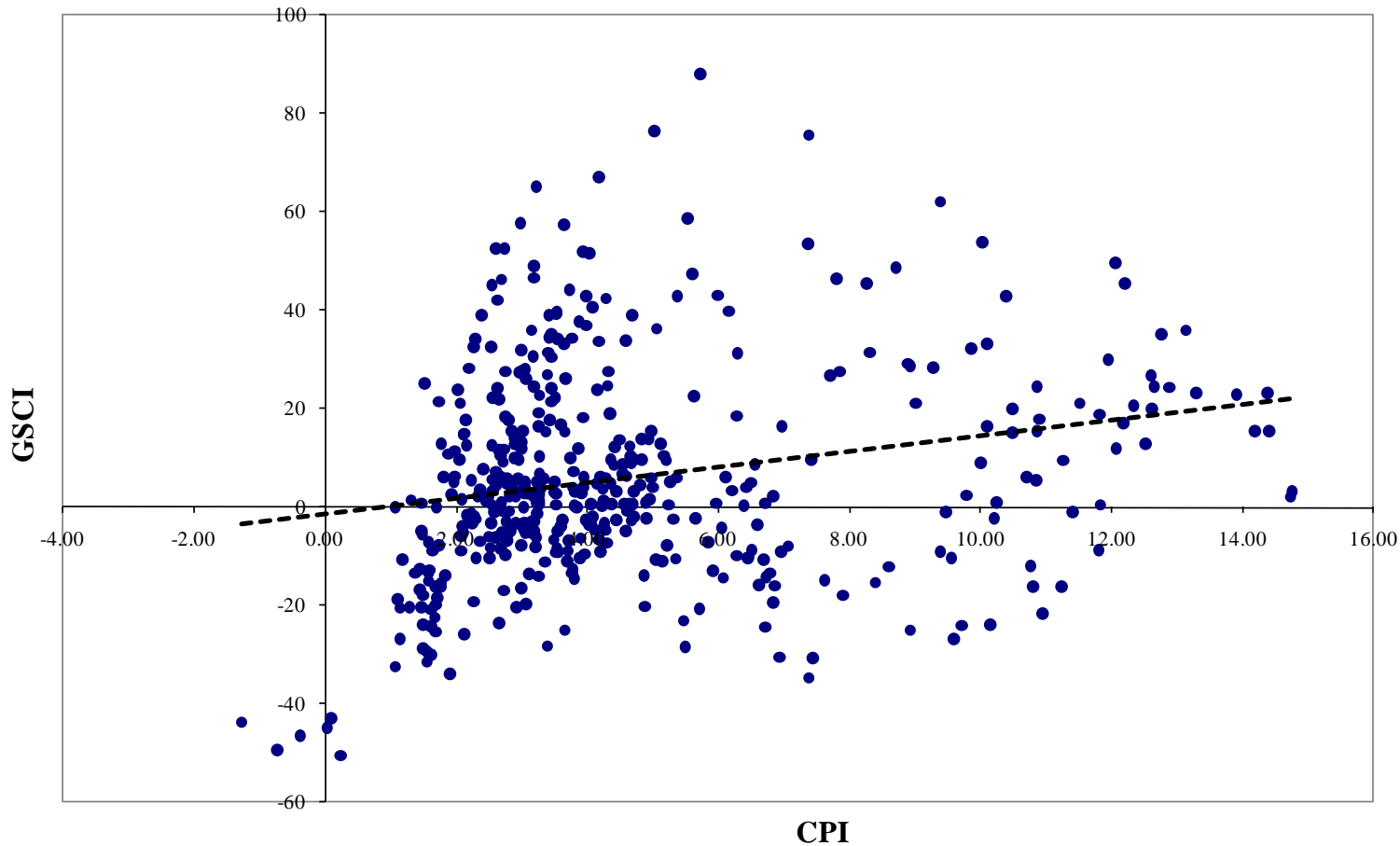
TIPS – Positively Correlated with Inflation



Regression Equation: $TIPS = 3.8432 + .5671 CPI$
 $R^2 : 0.2366$

- Include basic resources such as iron ore, coal, oil, wheat, gold
- Traded through futures contracts on exchanges
- Serve as production inputs whose prices rise in tandem with broad economic activity
- Exhibit positive relationship with general price levels of goods sold in the market
- Invest through commodity indices or active commodity managers using futures

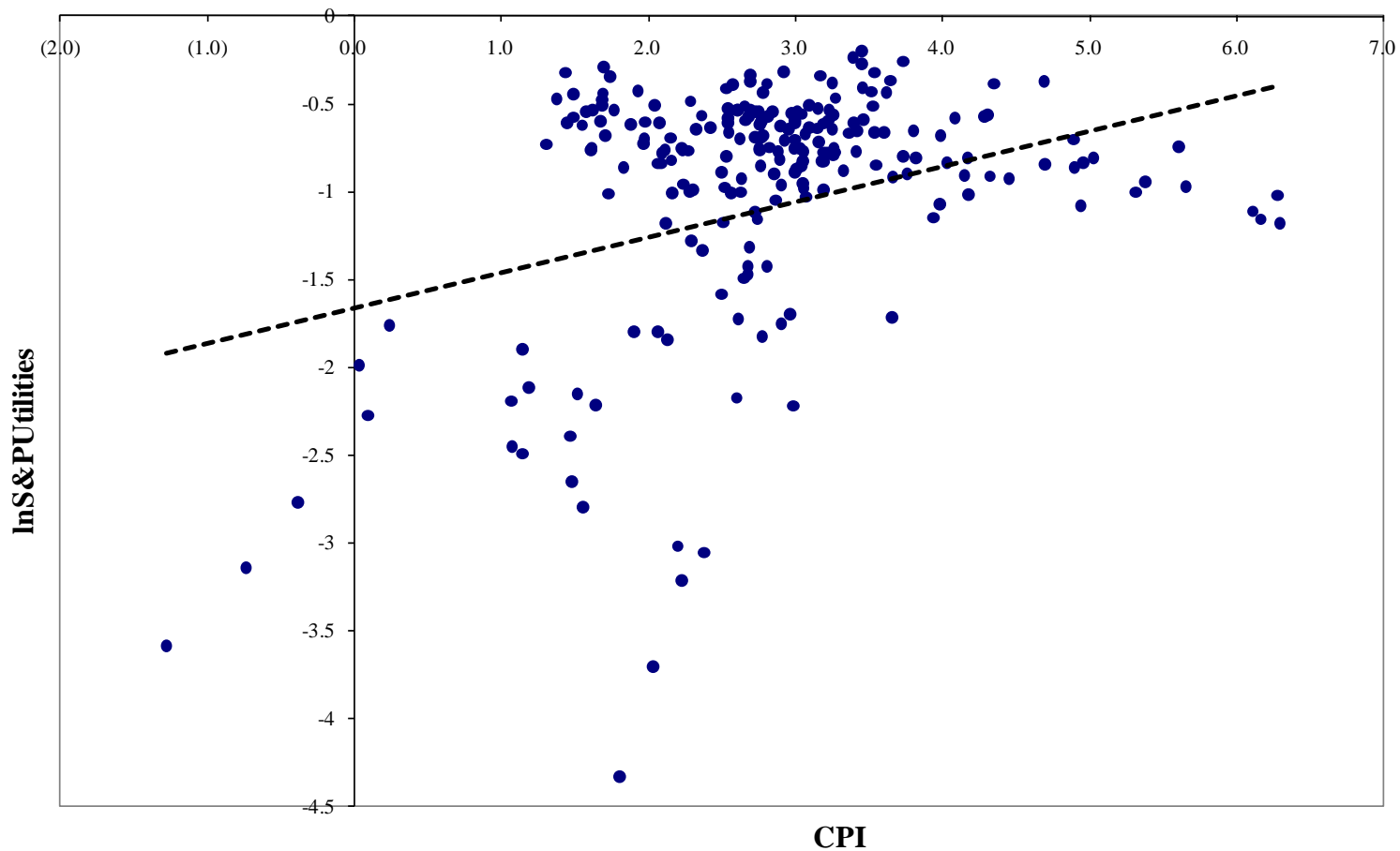
Commodities – Positively Correlated with Inflation



Regression Equation: $GSCI = -1.2026 + 1.5829 CPI$
 $R^2 : 0.0514$

- Includes basic physical systems
 - Transportation, communication, water, electricity
- Consumers are relatively insensitive to price movements
 - Lack of better or cheaper substitutes
- Highly regulated assets often with government concessions
 - Governments often explicitly tie prices to inflation index such as CPI
- Lacks universal index to track performance
 - S&P 500's Utilities sector is a reasonable proxy

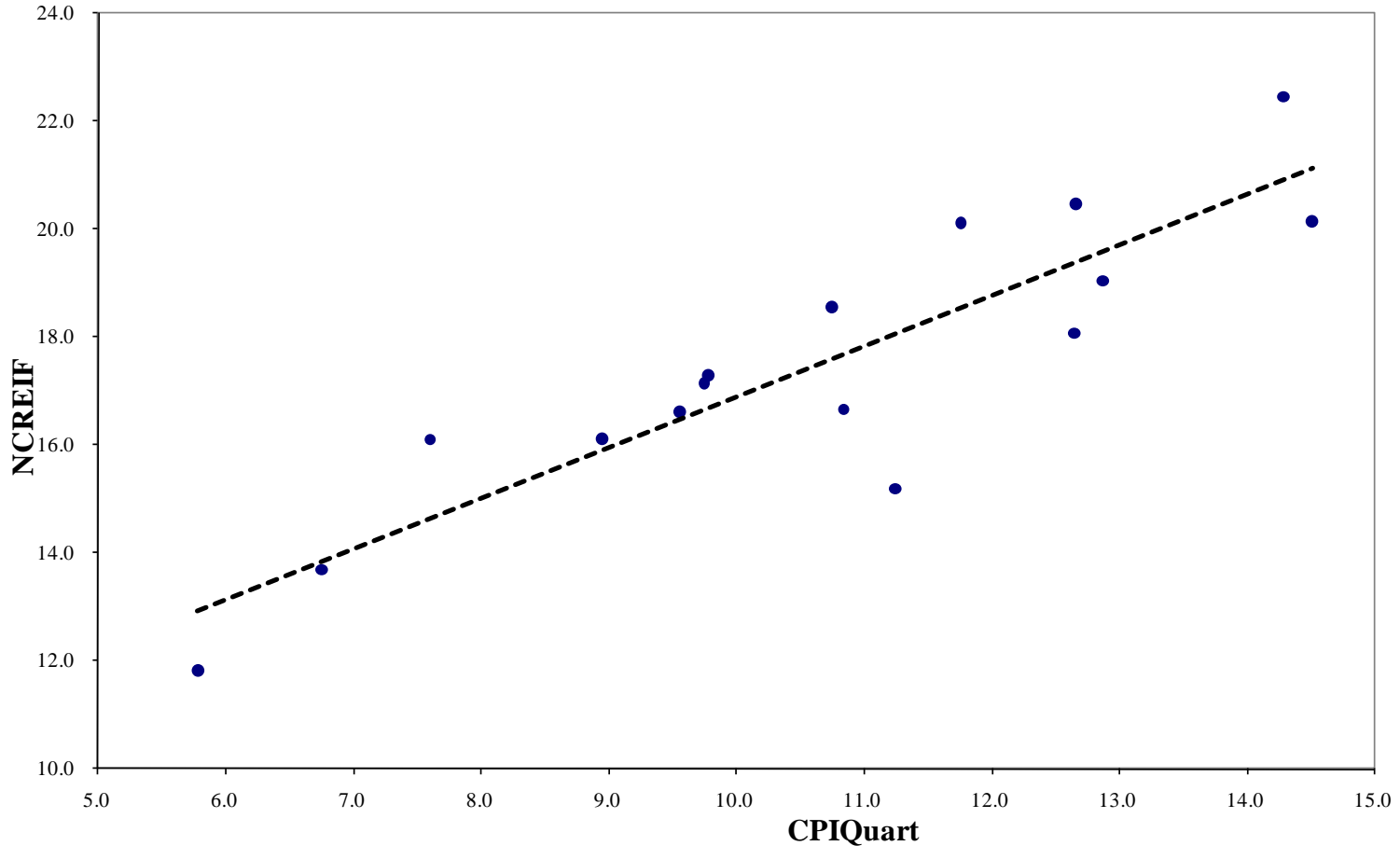
Infrastructure – Positively Correlated with Inflation



Regression Equation: $\ln S\&PUilities = -1.6650 + .2015 \text{ CPI}$
 $R^2 : 0.0106$

- Land and any other asset permanently affixed to it
- Divided into private and public markets
 - Private markets measured by the NCREIF index
 - Public markets consist of REITs; impacted by daily market liquidity
- Property owners can raise rents to offset higher input costs during inflation
- Long-term inflation protection due to long-term nature of contracts

Real Estate – Positively Correlated with Inflation



Regression Equation: $NCREIF = 7.4962 + .9405 \text{ CPIQuart}$
 $R^2 : 0.7859$

- TIPS, commodities, infrastructure and real estate offer protection from high inflation
 - Asset returns positively correlated with CPI
- Each asset class has unique characteristics impacting portfolio performance
 - Beware of blindly choosing asset class with highest fit and correlation
- Analyze risk tolerance, liquidity needs, diversification benefits, and investment policy guidelines

Asset Class	R ²	Correlation	CPI Coefficient
TIPS	0.2366	0.4864	0.5671
S&P GSCI	0.0514	0.2267	1.5829
S&P Utilities	0.0106	0.1029	0.2015
NCREIF (Real estate)	0.7859	0.8865	0.9405

Investment Perspectives

Viewpoints for Clients

*Fourth Quarter
2009*

2010 MARKET PREVIEW

OVERVIEW

Gregory J. Leonberger, FSA, Director of Research

Though the scars of the 2008 financial crisis remain, 2009 helped to alleviate some of the pain as financial markets rallied and tidbits of positive economic news emerged. Most major stock indices posted positive returns in 2009, and the bond market held steady (with the exception of U.S. Treasuries coming back to earth), with sectors such as high yield and senior secured loans recording record returns. Alternative asset classes had more of a mixed 2009: hedge funds reversed their 2008 struggles, while debt access and legacy assets continued to haunt the real estate and private equity markets. On the economic front, GDP turned positive in the third quarter, perhaps signaling that the recession was over and brighter days lie ahead. Despite these facts, many questions still remain. Has the stock market rally outpaced the economic recovery? What should we expect from alternative asset classes? Is inflation a threat to the economy? When will banks resume normal lending practices? Will the unemployment rate improve?

In the following articles, we will take a closer look at each asset class, examining the major news items from 2009, as well as critical issues for 2010. Each article contains insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classes covered. Articles are offered for the following asset classes: fixed income, domestic equities, international equities, hedge funds, real estate, infrastructure, and private equity. As a launching point, we take a broad view of the economy and examine some crucial macroeconomic topics as they pertain to the U.S. economy. ■

U.S. ECONOMY: MIXED SIGNALS

Gregory J. Leonberger, FSA, Director of Research

Despite the encouraging returns from financial markets in 2009, broad economic measures provided mixed signals on the health of the U.S. economy. Economic growth, as measured by the Gross Domestic Product (“GDP”), finally turned positive in 2009’s third quarter, leading many to conclude that the recession had reached its end. Estimates for 4th quarter GDP indicate further growth similar to the 3rd quarter rate of 2.2%, with 2010 and 2011 projections in the 2 – 3% range. Though the news of positive economic growth is a welcome sign to all, past recoveries have featured notably higher growth coming out of a trough, especially major recessions:

M Marquette
Associates

Integrity ♦ Diligence
Solutions

Overview

-Page 1

U.S. Economy

-Page 1

Fixed Income

-Page 6

U.S. Equities

-Page 9

International Equities

-Page 13

Hedge Funds

-Page 16

Real Estate

-Page 18

Infrastructure

-Page 22

Private Equity

-Page 25

Marquette Associates, Inc.
180 North LaSalle Street
Suite 3500
Chicago, IL 60601
www.marquetteassociates.com

<i>Recessions</i>	<u>GDP</u>	
	<u>Recession</u>	<u>Recovery</u>
Minor		
2001	-0.2%	1.9%
1970	-0.6%	4.2%
1991	-1.3%	2.7%
1960	-1.6%	7.5%
Major		
1953	-2.7%	7.8%
1982	-2.7%	7.7%
1975	-3.1%	6.1%
1957	-3.7%	9.5%
Average	-1.9%	5.7%
<i>Current recession*</i>	-3.9%	3.3%

Source: Bank of America Merrill Lynch Global Research

*Current recession includes BA-ML estimate; recovery is first four quarters

The data above confirms what many analysts have suggested: unlike previous recoveries, the rebound from this recession will be a long slog instead of a rapid bounce back. So while signs of positive economic growth are good, conservative estimates of future expansion are recommended.

Perhaps the most troubling economic trend over the last two years has been unemployment. Since the official start of the recession in December 2007, the unemployment rate has grown by 5% and 7.6 million jobs have been lost. Job losses have been especially heavy in construction and manufacturing. During 2009, the unemployment rate continued its steady climb, cresting at 10.2% in October before ending the year at 10.0%.

In reality, the unemployment percentage in the U.S. is considerably higher, as those who have given up looking for a job are not counted in the actual statistic. The government's broader measure of unemployment, the "U-6" unemployment figure, accounts for people who have stopped looking for work or who cannot find full-time jobs. In December, the U-6 unemployment rate was 17.3%, meaning that close to one out of five workers in the U.S. does not have a job. Looking into 2010, analyst estimates indicate the unemployment rate approaching 11.0% before gradually improving: Slow economic growth coupled with discouraged workers returning to the labor force will contribute to the uptick in unemployment before any improvement is seen. Since economic recovery is expected to be slow and unemployment lags the overall economy, any improvement to the jobs situation is not likely to come until the second half of 2010.

Given the record amounts of monetary and fiscal stimulus over the last 16 months (more on this later), many investors are becoming concerned about potential inflation and its impact on the economy. To date, inflation has not become an issue: year over year inflation in 2009 was 1.7%¹, hardly a figure to be concerned about.

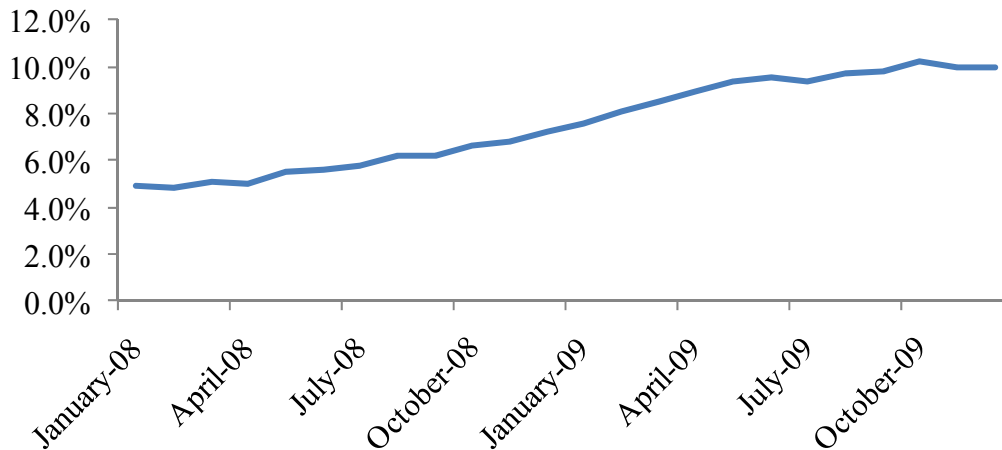
*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

“... unlike previous recoveries, the rebound from this recession will be a long slog instead of a rapid bounce back. .”

Unemployment Rate, 2008 - 2009



*Fourth Quarter
2009*



But as quantitative easing continues into 2010, many worry that at some point all the liquidity (cash) pumped into the economy will lead to rapid price escalation. However, there are several factors which suggest that inflation is not a threat to the economy in 2010:

“...there are several factors which suggest that inflation is not a threat to the economy in 2010.”

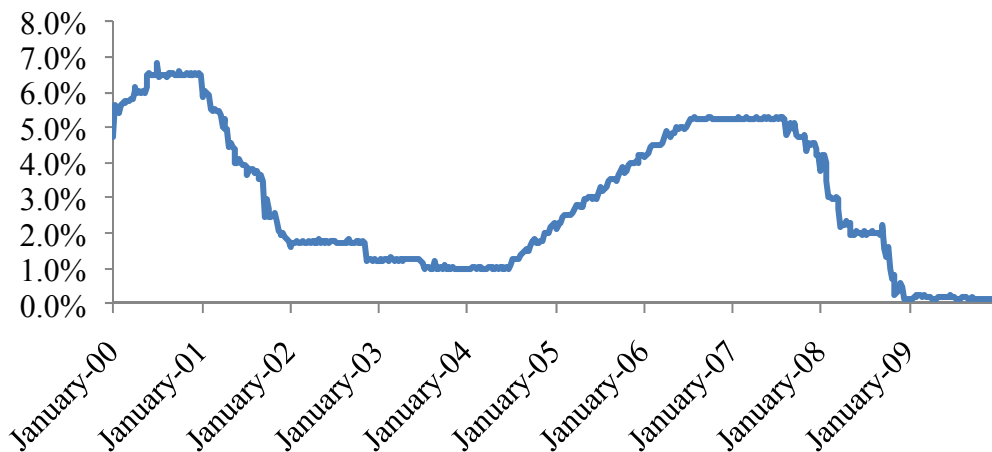
- Lack of Bank Lending – although the M2 money supply² has grown by approximately \$1,150 billion since September 2008³, banks have been hesitant to lend money, instead choosing to rebuild their balance sheets. Without the excess bank liquidity getting into the economy via bank lending, it is nearly impossible for spending to increase enough to cause inflation.
- Excess Capacity – spare capacity is at or near record highs, as companies have slashed workforces and outputs to survive during the recession. Consequently, when demand returns, it will be relatively inexpensive to increase production without creating upward price pressure.
- Wages – as long as unemployment remains high, nominal wages are likely to be held in check, since workers have relatively little bargaining power – with an oversupply of labor, workers are forced to accept the prevailing market wage – therefore putting very little upward pressure on wages and, in turn, inflation.
- Slower Recovery – since the economic recovery is expected to be slower than past recoveries, general price increases should also follow suit and rise slowly, further contributing to lower inflation.

Indeed, estimates for expected inflation in 2010 reflect these above trends, with most predictions in the 2 – 3% range. Unless the above factors radically change (i.e. bank lending takes off, wages skyrocket and / or GDP growth escalates rapidly), inflation should not be a credible threat to the U.S. economy in 2010.

As mentioned earlier, U.S. policy response to the financial crisis of 2008 has been

massive, with commitments exceeding \$12 trillion. For the sake of comparison, 2008 GDP was \$14.2 trillion, while the cost of World War II for the U.S. in today's dollars was \$3.6 trillion⁴. The majority of commitments have been initiated by the Federal Reserve ("Fed"), whose programs have totaled close to \$8.0 trillion, primarily through the purchase of Mortgage Backed Securities ("MBS") and long-term treasuries. Through large purchases of these assets, the Fed has been able to keep interest rates extremely low; this process is known as "quantitative easing." For example, the Federal Funds Rate has hovered close to zero for the last year, well below historical levels. The dramatic drop is illustrated by the graph below:

Effective Federal Funds Rate, 2000 - 2009



The theory of quantitative easing is that low interest rates will promote bank lending and subsequent economic growth. At this point, the results are still mixed: Interest rates have remained low, but economic growth has been slow. Looking into 2010, the Fed currently plans to stop purchasing MBS in March 2010, which has many worried that interest rates will rise as liquidity evaporates from the economy. This would appear to be a legitimate concern, since the Fed currently accounts for more than 70% of the purchases in the MBS market.⁵ Higher interest rates would help to combat potential inflation, but given the relatively low probability of high inflation in 2010, many have speculated that if interest rates increase too much, the Fed will resume their purchases of MBS. Currently, the Fed seems to believe the risks of disinflation are greater than the risks of rising price levels, given the excess capacity and high unemployment left from the recession. As a result, the Fed is more likely to maintain low interest rates for the benefit of the U.S. economy, at least until unemployment begins to improve.

In addition to the Fed's aggressive monetary policy to revive the economy, the U.S. Government also spent an unprecedented amount on stimulus programs to revive the economy. The table below highlights some of the major programs:

“Currently, the Fed seems to believe the risks of disinflation are greater than the risks of rising price levels...”

Stimulus Programs	Amount	Date
TARP (Troubled Asset Relief Program)	\$700 bn	October 2008 - Present
TALF (Term Asset Backed Lending Facility)	\$1,000 bn	March 2009 - Present
TLGP (Temporary Liquidity Guarantee Program)	\$300 bn	October 2008 - Present
American Recovery and Reinvestment Act	\$787 bn	November 2008 - Present
e.g. Cash for Clunkers	\$3 bn	June 2009 - August 2009
e.g. Homebuyer Tax Credit	\$8.5 bn	January 2009 - Present

Similar to the initiatives of the Fed's monetary policy, results have been mixed. Though these programs have provided a boost to the economy, there is a legitimate question of what will happen once these programs expire – will they have successfully formed a foundation on which to build a sustainable economic recovery, or were they simply a temporary fix?

Looking ahead to 2010, further fiscal stimulus will likely be limited. With a federal budget deficit projected to be approximately \$1.5 trillion⁶, concern over the amount of government spending is beginning to intensify, to say nothing of the dire budget shortfalls faced by many state and local governments. A second stimulus package is expected, but it will contain little more than an extension of current tax cuts and unemployment benefits - nowhere near the scope of the stimulus package passed last year.

As a whole, the U.S. economy appears headed in the right direction, though at a slower pace than most would like. Certainly, potholes on the road to recovery loom ahead – most notably sluggish growth, persistent unemployment, and mounting government budget deficits. The good news is that the worst is probably behind us. If GDP growth accelerates, jobs return to the economy and inflation does not become a detriment to economic health, we can look forward to brighter days ahead. ■

Sources:

¹JP Morgan Asset Management; Core CPI based on year over year data as of 11/1/2009

²M2 money supply is typically used by economists to quantify the amount of money in circulation

³Goldman Sachs Asset Management

⁴Baird Investments

⁵Mesirow Financial

⁶JP Morgan Asset Management

*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

“As a whole, the U.S. economy appears headed in the right direction, though at a slower pace than most would like.”

FIXED INCOME MARKETS IN 2009: THE RETURN OF RISK

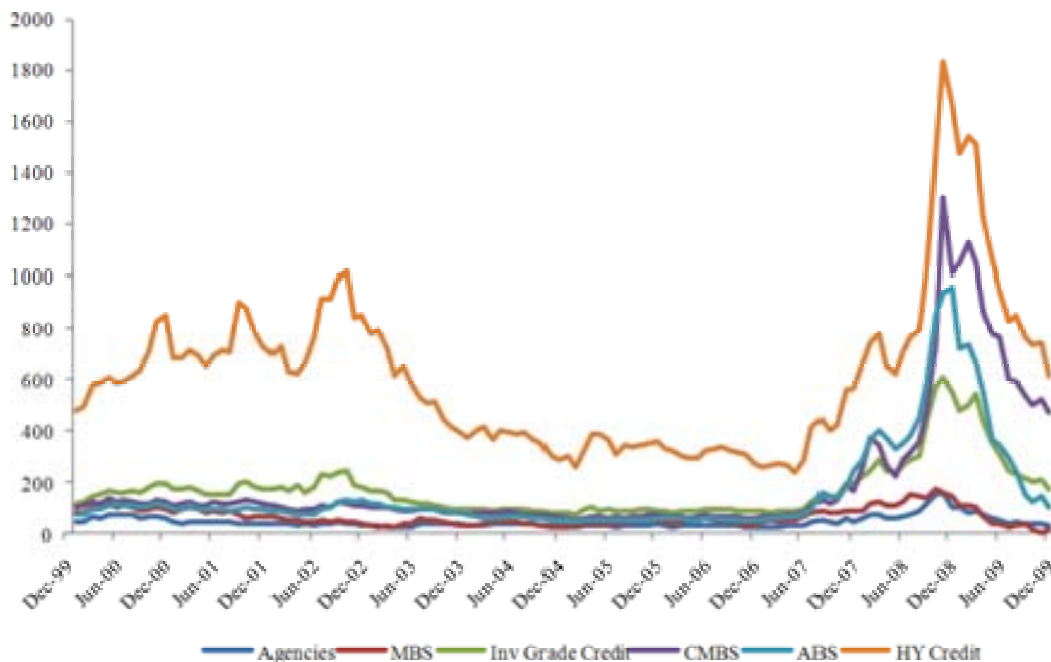
Michael E. Spychalski, Analyst

The dominant theme in the fixed income markets in 2009 was flight from quality, or “the return of risk”. This represents a complete reversal of the risk aversion and flight to quality that dominated the markets in 2008. The main cause of this dramatic reversal in risk appetite was the stabilization of the global financial system.

At the end of 2008, the markets were priced for a Great Depression like scenario, as evidenced by the fact that the Option Adjusted Spread (OAS) of every fixed income sector was at a record level. In the face of immense fear and uncertainty in the markets, there was a coordinated effort on behalf of developed market countries to rescue the economy from the brink of disaster through a combination of extremely low interest rates, quantitative easing, and unprecedented economic stimuli. These drastic steps were effective in reducing systemic risk and increasing confidence in the markets.

By the end of the first quarter of 2009, investors were faced with a more stable global financial system, historically low yields on U.S. Treasuries, and historically wide spreads on riskier assets. With the global economy no longer on the brink of disaster, an appetite for risk returned to the market, and investors began searching for more yield. Money started pouring into riskier assets and there was an extreme reversal in spreads (measured in basis points), which is illustrated in the chart below.

Option Adjusted Spreads



Source: Barclay's Capital

Fourth Quarter
2009

M Marquette
Associates

Integrity • Diligence
Solutions

“With the global economy no longer on the brink of disaster, an appetite for risk returned to the market, and investors began searching for more yield.”

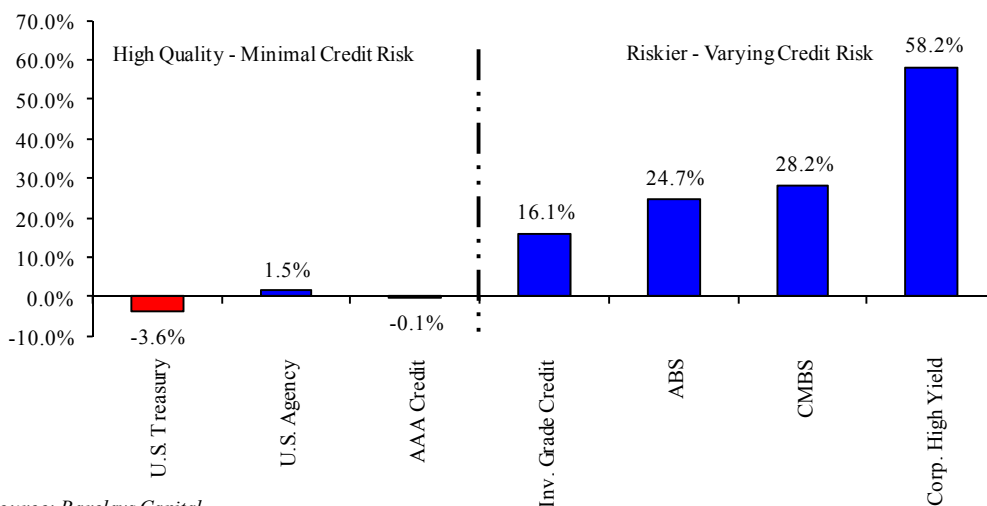
Continued from page 6

This massive flight from quality into riskier assets resulted in significant outperformance for all non-government sectors in 2009. The three worst performing sectors in 2008 - Asset Backed Securities (ABS), Commercial Mortgage Backed Securities (CMBS), and High Yield bonds (with returns of -12.7%, -22.7%, and -26.2% respectively) were the best performing sectors in 2009 (with returns of +24.7%, +28.2%, and +58.2% respectively). Conversely, the three best performing sectors in 2008 - U.S. Treasuries, U.S. Agencies, and AAA Credit (with returns of +13.7%, +9.3%, and +8.2% respectively) were the worst performing sectors in 2009 (with returns of -3.6%, +1.5%, and -0.1% respectively).

**Fourth Quarter
2009**



Fixed Income Sector Performance 12/31/08 - 12/31/09

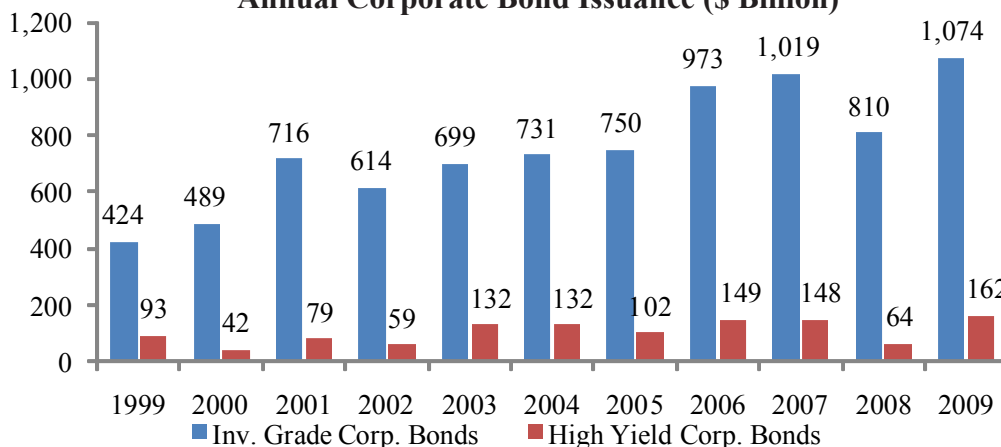


Source: Barclays Capital

The increased demand for risky assets allowed companies to issue new debt throughout the year. The chart below shows the annual corporate bond issuance for investment grade and below investment grade companies since 1999. After a significant drop off in corporate bond issuance in 2008, the market picked up significantly in 2009 and both investment grade as well as below investment grade companies issued a record amount of debt over the course of the year.

“After a significant drop off in corporate bond issuance in 2008, the market picked up significantly in 2009...”

Annual Corporate Bond Issuance (\$ Billion)

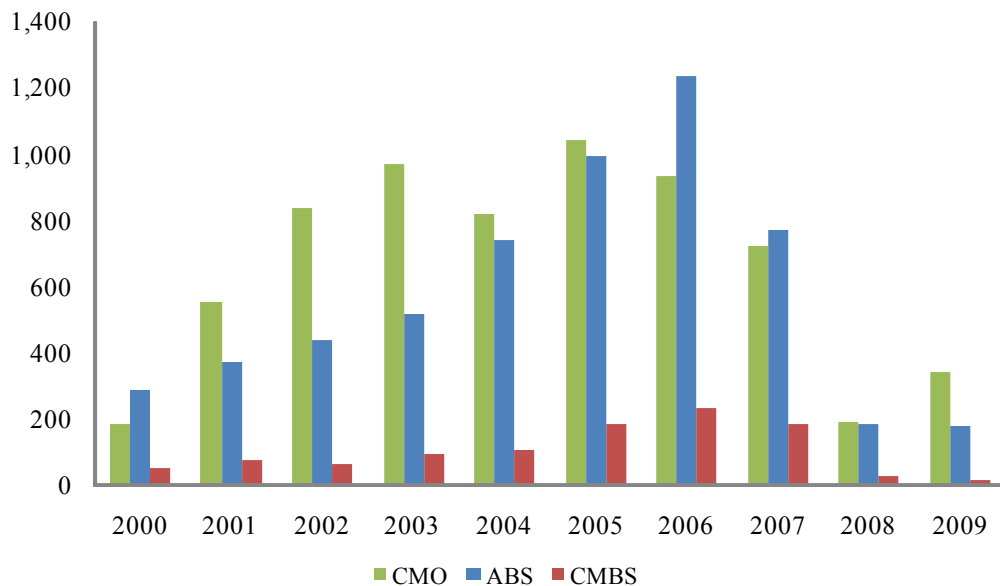


Source: Bloomberg

Continued from page 7

The securitization markets did not recover nearly as well as the corporate bond market did in 2009, but they did start to show some signs of life in the second half of 2009. The chart below shows the significant drop off in annual issuance of Collateralized Mortgage Obligations (CMO), ABS, and CMBS. Furthermore, while the securitization markets are slowly beginning to function again, they are only doing so because they are being supported by government programs such as the TALF.

Annualized Securitized Issuance (\$ Billion)



Source: Bloomberg

Fixed Income 2010 Outlook

While 2008 was a year dominated by extreme risk aversion and spread widening, and 2009 was a year dominated by an extreme appetite for risk and spread tightening, 2010 will likely be a year when the fixed income markets behave in a much more normal manner. However, uncertainty regarding near term inflationary pressures, possible changes in the Federal Reserve's easy money policy, the removal of government programs that helped support the markets, and the potential for defaults from corporations as well as sovereign countries pose risks that could result in another headline year for fixed income in 2010.

The technical imbalances that drove the fixed income markets to extremes in 2008 and 2009 have mostly been corrected, and the "easy" money has already been made in fixed income. The markets will likely return to an environment where fundamental valuations of individual securities will outweigh technical market conditions, and bottom up security selection will be critical in 2010.

Although inflation is currently not a problem, the potential for inflation in the near term has the potential to be the main driver of fixed income performance in 2010.

**Fourth Quarter
2009**

**M Marquette
Associates**

Integrity ♦ Diligence
Solutions

"...2010 will likely be a year when the fixed income markets behave in a much more normal manner."

If inflationary pressures start to build, the Federal Reserve will have to respond by raising interest rates. Since bond prices have an inverse relationship to interest rates, increases in interest rates will cause bond prices to fall, which erodes bond returns. Based on Fed Funds futures contracts, the market is currently expecting the Federal Reserve to keep rates unchanged for the first half of 2010 and then gradually raise rates in the second half of the year. If inflation remains under control and the Federal Reserve keeps interest rates relatively low, 2010 has the potential to be another solid year for fixed income. However, if the Federal Reserve has to raise interest rates more aggressively to combat inflation, it will likely be a difficult year for bonds. ■

U.S. EQUITY: A FAST AND FURIOUS MARKET RECOVERY

Kelli A. Schrade, Director of Manager Research

Coming on the heels of one of the worst bear markets in U.S. history, 2009 was an incredibly positive year for U.S. equity money managers. While every broad U.S. equity asset class posted a negative return in 2008, U.S. equity investors reaped double-digit positive gains this year from small cap to large cap. The following chart depicts each respective Russell index and its corresponding ranking within its peer group. For example, the Russell 1000 Value (top left cell) gained 14.85% through September 30, 2009, which ranks in the 70th percentile. A ranking in the 100th percentile is the worst in the group; conversely, the 1st percentile is the highest.

Index Performance in 2009

	Value	Core	Growth
Large	14.85% 70th	19.26%* 52nd	27.11% 38th
Mid	27.57% 54th	32.63% 26th	37.12% 27th
Small	16.36% 83rd	22.43% 63rd	29.12% 52nd

For the most part, 2009 was a year for active managers to shine. In almost all asset classes, the index trailed its median active peer. In small value, for example, the median product returned 26%, that is, 50% of small value vehicles had a higher return, and 50% had a lower return. Meanwhile, the Russell 2000 Value returned 16%, thus proving that active management clearly added value beyond what the index provided during the year. This observation held true in almost all asset classes.

Most active managers strive to construct differentiated portfolios from their respective indices. In small-cap value, for example the average manager has 24% of assets in financial stocks vs. a 34% weighting for the index. While that hurt active managers back in 2008's third quarter, when small regional banks dominated returns, it helped in this year's market.

“...U.S. equity investors reaped double-digit positive gains this year from small cap to large cap.”

Leading the Rally

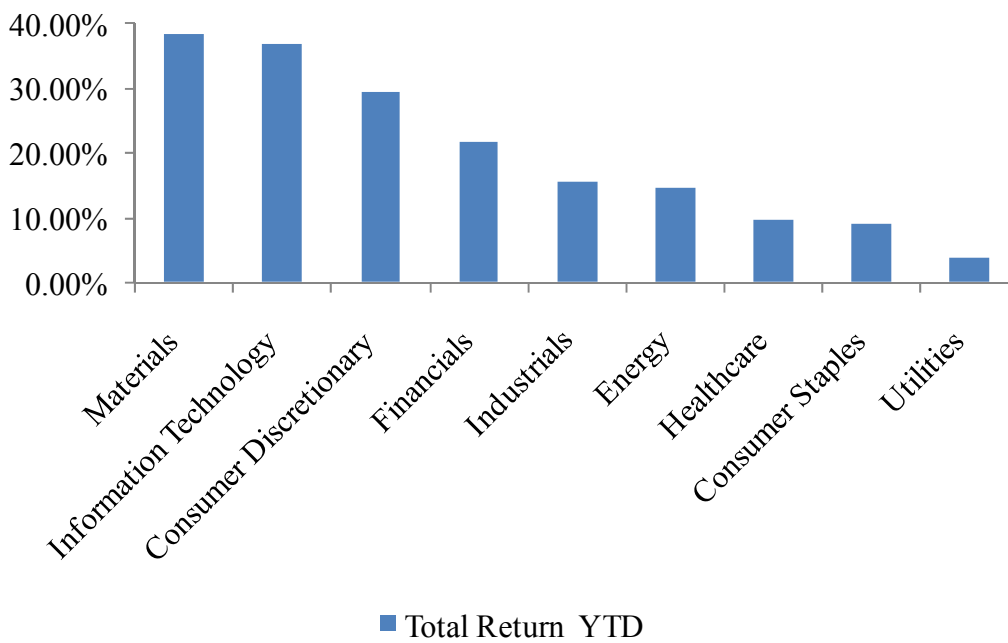
Even in 2009 when all asset classes produced solid absolute returns, certain sectors led the market rally. Growth products outperformed their value counterparts. This is not surprising given their large allocations to soaring technology stocks. The Russell Mid-Cap Growth index, with 23% of assets dedicated to technology stocks, posted the best calendar year return within domestic equity (+46.3% in 2009). The following chart depicts the performance of the sectors within the S&P 500. More cyclical sectors such as materials, technology and consumer discretionary stocks performed the best, while defensive sectors like health care and consumer staples lagged.

*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

S&P 500 Sector Performance in 2009



“Improved company earnings in 2009 were not solely driven by the U.S. economy or cost cutting.”

Source: Morningstar Direct. Data through 9/30/2009

Improved company earnings in 2009 were not solely driven by the U.S. economy or cost cutting. More and more, we see a global reach within U.S. stocks. Companies in the S&P 500 index receive 49% of their sales from outside the U.S., up from 30 percent in 2001, according to Standard and Poor’s¹. Firms like McDonalds have long had a presence abroad, but other firms like 3M are drawing more revenue from Asia, as industrialization increases in developing markets.

A Wild Ride

While 2009’s returns look strong, they mask the market volatility we’ve experienced. The market began 2009 just as 2008 had ended. Returns in January and February were downright miserable. However, a dramatic swing upward began on March 9. Across all asset classes, performance in March and April picked up dramatically. This was especially true among small cap and mid-cap stocks, who were the best performers during those two months.

Many pundits have pointed to the “low-quality” nature of the market’s second quarter rally. Not only did we see cyclical stocks take off during this period, but many domestic stocks priced less than \$5 rallied hard. Although it may seem overly simple or arbitrary, many investors consider the \$5 threshold an important one. Many big investment firms are prohibited from owning stocks priced under \$5 because they are considered too risky. The SEC’s definition for a “penny stock” is one under \$5, which is not traded on a major exchange such as Nasdaq or the NYSE. Many of Marquette’s separate account guidelines prohibit ownership in those kinds of delisted stocks.

These sub-\$5 stocks, however, drove much of the market’s gains in March and April, particularly in small cap. The following table exhibits the number of sub-\$5 stocks in each of the small-cap indices at market close on Friday, March 6, 2009. The amounts are significant, with each index dedicating more than 20% of its assets to these types of stocks. When the market reopened on Monday, March 9, the subsequent performance through April 30 is nothing short of remarkable. Sub-\$5 stocks drove the returns of their respective indices, with dramatic triple digit returns. This lone 6-week period in 2009 can make the difference between an active manager underperforming or outperforming for the calendar year.²

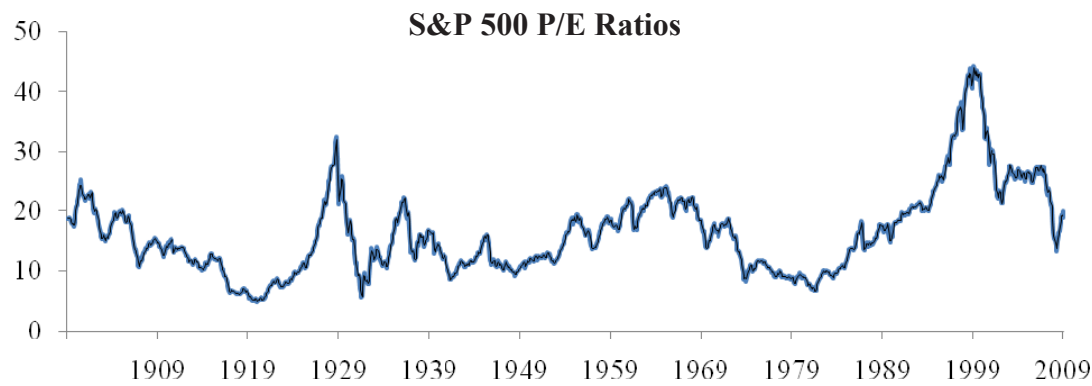
“Sub-\$5 stocks drove the returns of their respective indices, with dramatic triple digit returns.”

Index	# of Stocks Priced Less than \$5 on March 8	% of Index Priced Less than \$5 on March 8	Avg Return of >\$5 stocks from March 9 - April 30	# of >\$5 stocks with 100%+ Returns from March 9 - April 30
Russell 2000 Value	534	29%	111%	210
Russell 2000	758	25%	102%	255
Russell 2000 Growth	468	22%	92%	131

Does this Rally Have Steam?

While returns in 2009 have been remarkable, some have wondered if the U.S. equity market has run too far ahead of itself. On a valuation basis, the S&P 500’s current price/earnings ratio is 20, as of December 2009. From a historical vantage point, that level is above the historical average of 16. Even looking at P/E ratios from 1950 through today, the average P/E ratio is 18, still below today’s level. The graph below shows the historical P/E of the S&P 500 based on average inflation-adjusted earnings from the previous 100 years. Based on this metric, the market looks fairly valued.

Continued from page 11



Source: Data courtesy of Robert Shiller, Yale Department of Economics. P/Es are based on average inflation-adjusted earnings from the previous 10 years (P/E10). Data from 1/1/1900 – 12/1/2009.

Looking Forward to 2010

Famed investor Bill Miller said in his second quarter commentary this year, “Bull markets typically begin when the following four conditions are present: the economy is bottoming, profits are bottoming, the Fed is stimulating, and valuations are low.”³ While those elements appear to be present in 2009, there are still questions regarding whether the macroeconomic outlook will catch up with the roaring stock market. Question marks regarding the U.S government execution of stimulus dollars, home foreclosure rates, the weak dollar, and pending health care legislation are just some of the larger issues that could negatively affect the stock market as we head into 2010.

While investors are likely happy that 2009 didn’t end up as a repeat of 2008, the next year could present challenges to the U.S. equity market. Two key issues going forward will be:

1. The U.S consumer drove GDP spending for the last 20 years. If the overall economy improves and unemployment levels fall in 2010, will consumers return to their old habits of spending freely?
2. U.S. businesses cut costs in 2009, helping boost earnings. Will earnings remain sustainable into 2010 from actual bottom-line revenue growth instead of cost cutting?

As we go into 2010, one thing remains clear: We live in a global economy. Last year’s recession and this year’s recovery have been felt on a worldwide basis. While the U.S. remains the world’s largest economy, investing in the U.S. stock market involves an understanding of world economic conditions more than ever before. ■

Sources:

¹ Tsang, M. and Cimino, A. (2009, October 12). Rallying S&P 500 Never Cheaper in Europe on Dollar. Retrieved January 7, 2009 from Bloomberg’s website: <http://www.bloomberg.com/apps/news?pid=20601087&sid=aTInPG0YoeYo>

² This analysis took stock prices at the market close on March 6, 2009. Returns are then measured from March 9, the next trading day, through April 30, 2009.

³ Miller, B. (2009, July 19). Bill Miller Commentary. Retrieved January 7, 2009 from Legg Mason’s website: http://www.lmcm.com/pdf/miller_commentary/2009-07_miller_commentary.pdf

*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

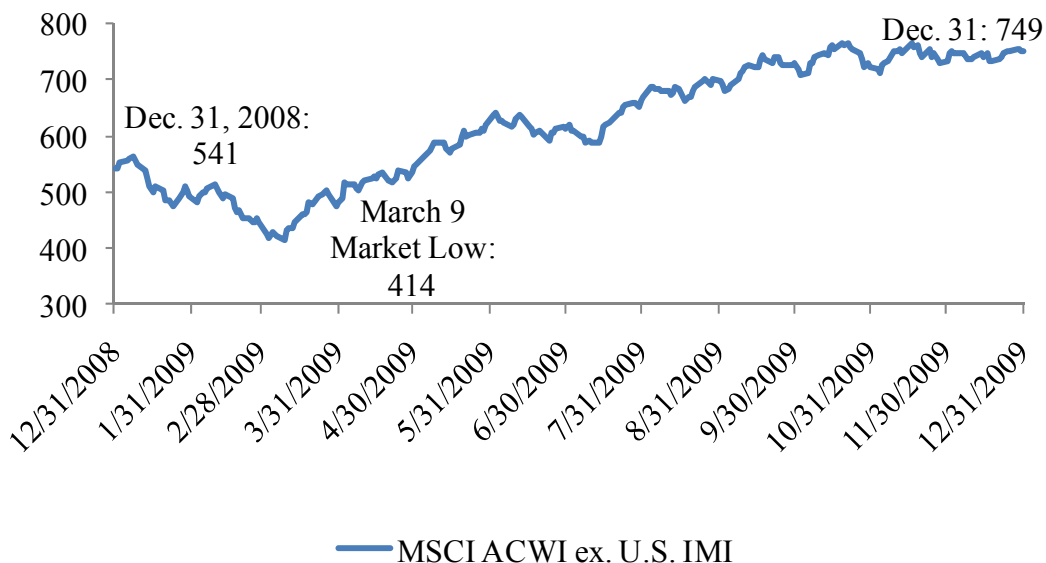
“...there are still questions regarding whether the macroeconomic outlook will catch up with the roaring stock market.”

INTERNATIONAL EQUITIES: EMERGING MARKETS LEAD THE REBOUND IN 2009

Lucas D. Meagher, Analyst

At the beginning of 2009, foreign markets continued to experience aftershocks from the devastation brought on by the credit crisis of 2008. Declining sentiment, the strengthening dollar, and risk-shy investors bogged down many international markets into March, but along with the United States, international markets emerged from the market bottoms swiftly.

International Equities in 2009



Source: MSCI Barra

Emerging market countries soared past developed as investors sought comfort in regions with strong economic growth prospects. The MSCI Emerging Markets Index was up 79.0% in 2009 while the MSCI EAFE Index was up 32.5% for the year. Emerging markets outperformed due to large foreign inflows, better economic performance, and strong currency appreciation vs. the U.S. dollar. Emerging market equity funds had \$64.5 billion of inflows during 2009, which significantly pushed up prices in the developing world.¹ China has led the way out of the global recession by deploying unprecedented stimulus measures including large-scale infrastructure investments, which has also boosted domestic lending. Even though exports have been down, China's GDP is expected to have grown 8.4% for the year.²

The following chart depicts the effect currency movements had on international equity returns. Most regions posted strong local returns for the year, but the depreciating dollar strengthened returns for U.S. based investors. Lingering economic concerns combined with low interest rates have been cited as the main drivers of the dollar's depreciation and consequently higher international equity returns.

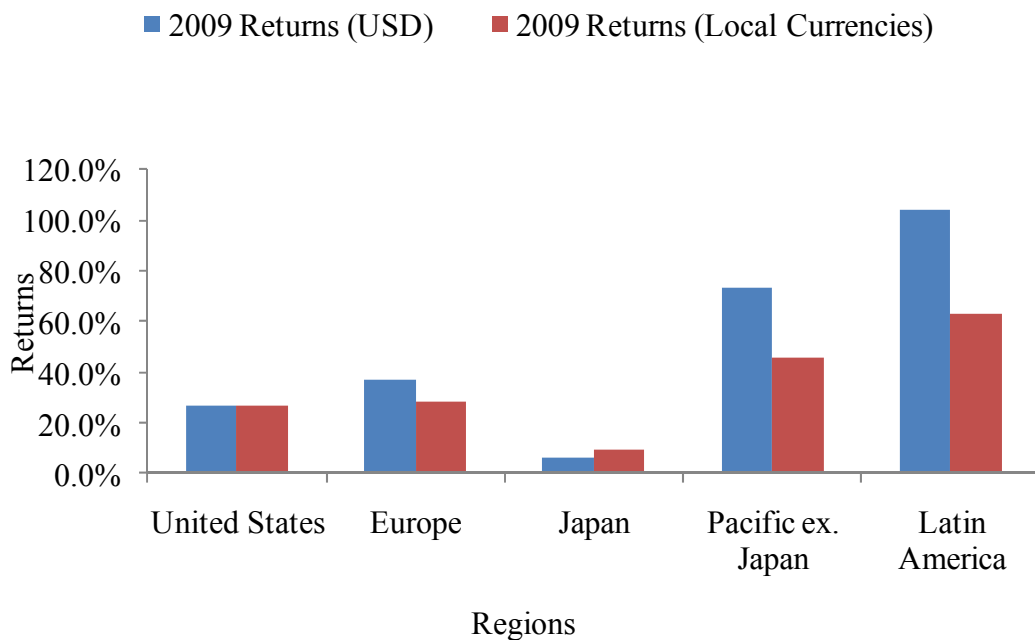
Fourth Quarter
2009

M Marquette
Associates

Integrity ♦ Diligence
Solutions

“Emerging markets outperformed due to large foreign inflows, better economic performance, and strong currency appreciation vs. the U.S. dollar.”

2009 Regional Returns



Source: Morningstar Encorr

Japan has lagged compared to other regions due to low economic growth prospects and large outflows from their equities. Latin America rebounded the most from 2008 as Brazil led the way with a 128.6% return in 2009.

Going into 2010 international equity performance is dependent upon multiple variables. Continued economic growth and rising consumer sentiment should further strengthen investor confidence in the New Year, but many challenges still remain. As government stimulus packages wind down and new stimulus proposals unlikely (or at best, small in size) due to massive government debt accumulations, economic growth will mainly depend on global businesses and consumers. An improved job market would significantly improve business and consumer prospects; therefore the unemployment rate is a key measure to monitor in 2010.

The chart below presents the expected GDP growth rate in 2010 for various developed and emerging countries. The BRIC nations (Brazil, Russia, India, and China) are expected to grow significantly more than developed markets. The attractive economic growth rate in the developing world has been the primary driver of the large inflows these areas have received, and may continue to receive. However, demand for emerging market equities could slow with some developing nations enacting foreign investment restrictions. For example, Brazil has imposed a 2% tax on foreign inflows to slow its rapid currency appreciation.

*Fourth Quarter
2009*

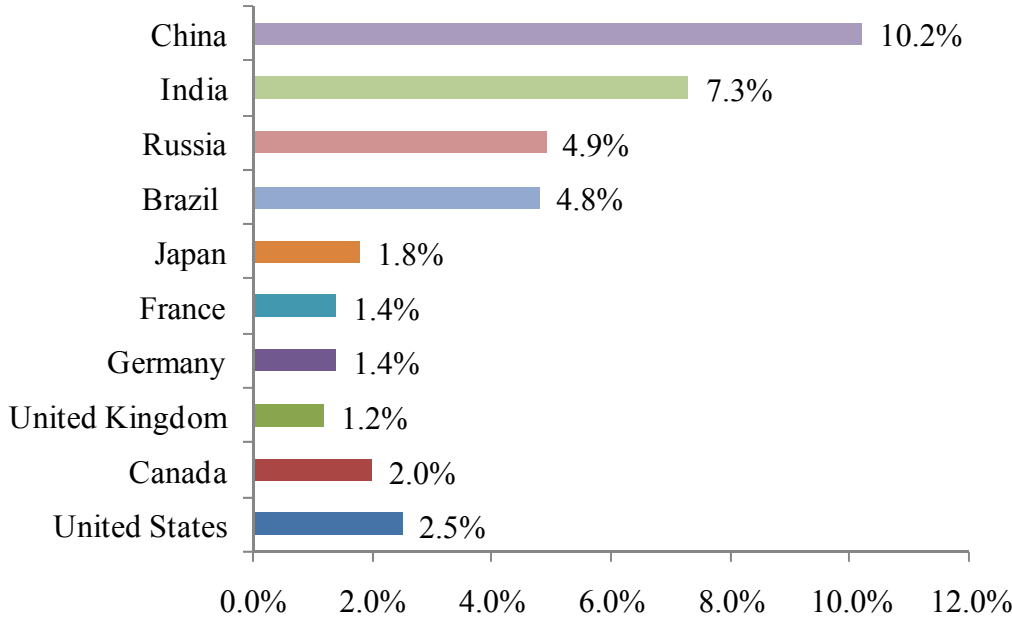


“...economic growth will mainly depend on global businesses and consumers.”



“With economic activity returning to positive levels, and a nine month rebound in the international equity markets, investor confidence seems to have been restored.”

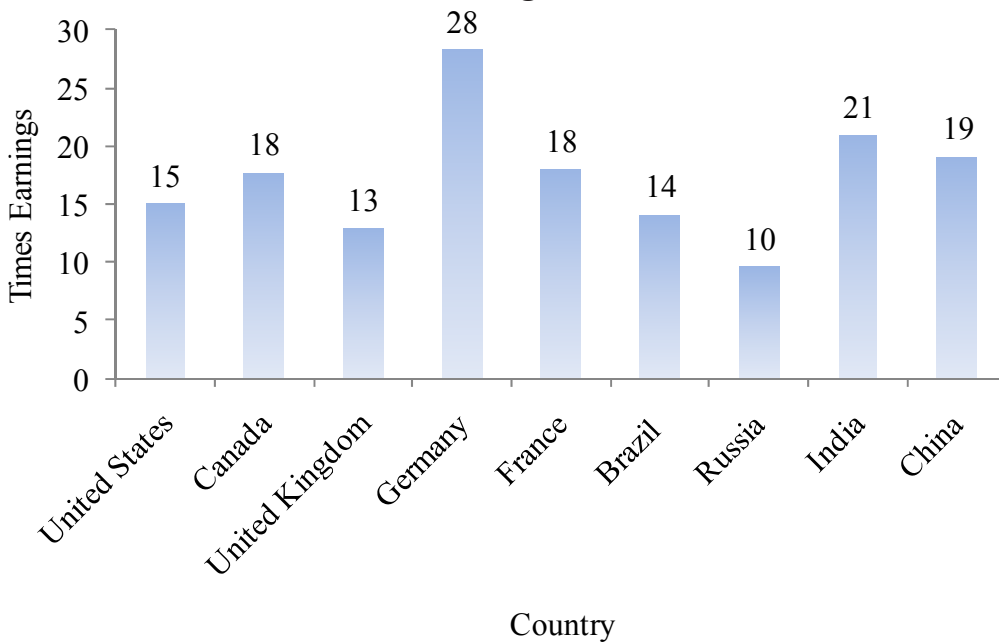
Projected 2010 GDP Growth



Source: MorOECD Economic Outlook Projection No. 86

Due to the strong rebound in 2008, it is important to analyze whether markets have come too far too fast. The chart below outlines the Price/Earnings (P/E) ratios of developed and emerging markets. There is wide dispersion in P/E ratios among individual countries; therefore tactical opportunities may exist for value-based investors in certain markets. Though emerging market equities vastly outpaced developed nations in 2009, their valuation average is lower than their developed peers, suggesting continued outperformance may occur.

9/30/09 Trailing P/E Ratios



From a global economic standpoint heading into 2010, prospects appear significantly more positive than they did going into 2009. With economic activity returning to positive levels, and a nine month rebound in the international equity markets, investor confidence seems to have been restored. As long as global economic stabilization and expansion continue, international equities should further appreciate. However, with many areas of the globe still on fragile footing, international equities may be volatile throughout 2010 as global economies work through their recoveries. ■

Sources:

¹ EPFR Global

² The World Bank

HEDGE FUNDS IN 2009: A SUCCESSFUL RECOVERY

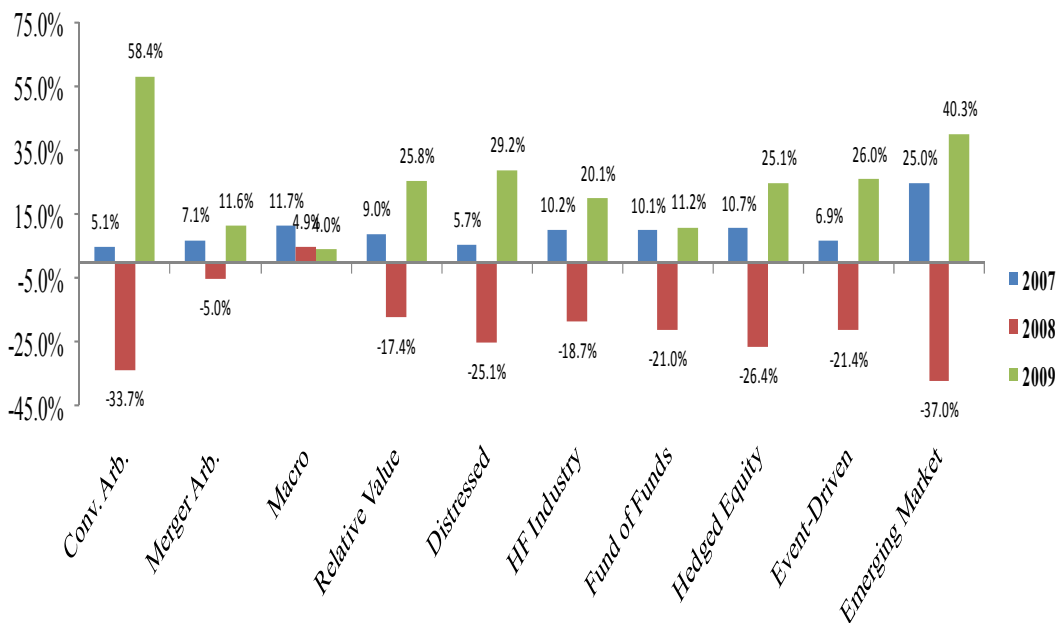
David J. Wernecke, Senior Analyst

The hedge fund industry finished 2009 much healthier than it began the year. As the year progressed, doomsday scenarios that had been predicted for hedge funds failed to materialize and managers were again able to focus on investing rather than the sustainability of their businesses.

Hedge funds provided absolute returns in the down market of the earlier part of the year then took a predominantly conservative stance during the market rally of the second and third quarters. Despite trailing the markets over that period, hedge funds remained on pace for their best performance over recent years.

“Hedge fund performance in 2009 was led by the strategies that fared the worst in 2008.”

A Reversal of 2008

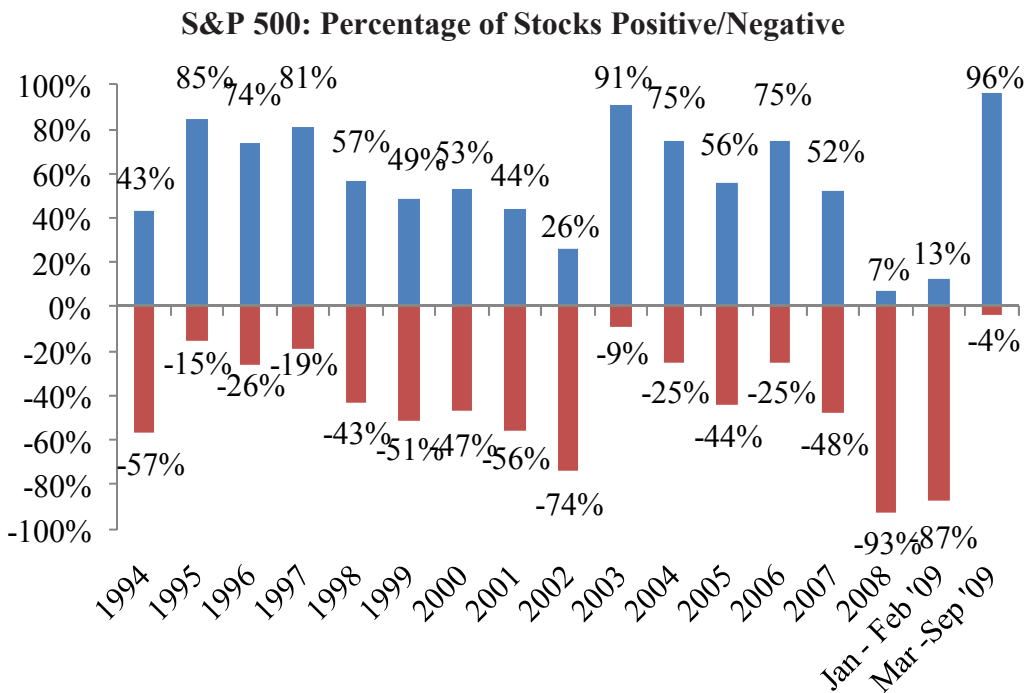


Source: HFR, Morgan Stanley

Hedge fund performance in 2009 was led by the strategies that fared the worst in 2008. After suffering a year of redemption pressures (convertible arbitrage) and poor equity markets (emerging markets) in 2008, both strategies were the strongest performers this year. Relative Value and Distressed strategies were broadly positive over the year as improving credit markets led to price recovery in bank loans, corporate credit and some types of mortgages. Conversely, Global Macro, which was the best performing strategy in 2008, trailed other strategies in 2009. Hedged Equity managers, although supported by rising markets, faced a difficult environment in the second and third quarters. Historically, hedged equity managers have lagged in strong bull market periods, which was a scenario that occurred in the middle of the year. The chart below shows the lack of dispersion between the “winners” and “losers” this year and the historical context. With only 4% of the stocks in the S&P 500 declining over the 2nd and 3rd quarters, short positions were a significant drag on portfolios. The last two columns in the chart divide 2009 and show the dramatic shift in market direction that occurred during the later portion of the year:



“Many investors sought managed accounts as a way to gain increased transparency and liquidity in light of some of the frauds that were exposed last year.”



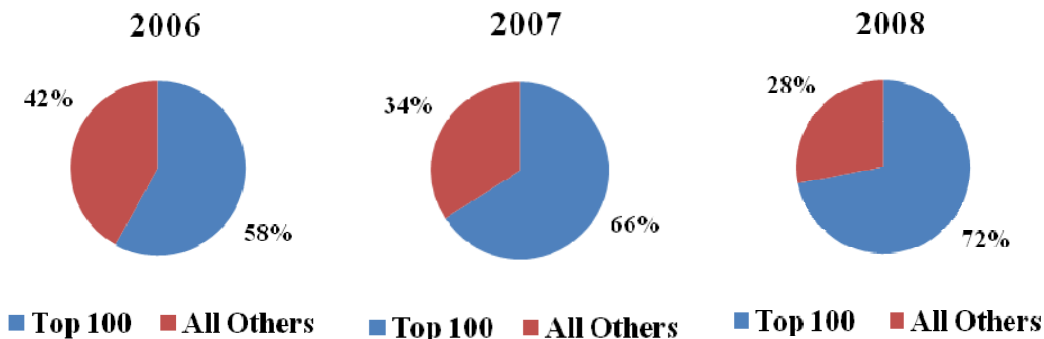
Source: ABS Investment Management

The Survivors Gain Traction

The anticipated shift of power in the hedge fund industry towards investors and away from managers took place in 2009 but not necessarily in the expected areas. Transparency was an area where investors were able to extract concessions from managers. Many investors sought managed accounts as a way to gain increased transparency and liquidity in light of some of the frauds that were exposed last year. One area where the balance of power has not shifted is manager fees. The industry

Continued from page 17

has become increasingly concentrated after many funds were forced to close last year. With limited new launches, it's estimated that the top 100 largest hedge funds now manage over 80% of the industry assets:



Source: Absolute Return, Alpha, Morgan Stanley

Looking Ahead to 2010

The outlook for hedge funds over the next year is positive as stability has returned to the asset class. A good number of hedge funds haven't followed the equity markets on their rapid rise of 2009 and have instead gained on the recovery of the credit markets. With the narrowing of credit spreads and the price recovery that occurred over the past year, there are fewer opportunities for simply taking long positions in credit. The opportunities for managers are much more situation specific including bankruptcies and restructurings. In equity-related strategies, managers remain conservatively positioned and many are still below their historical exposure ranges. With an uncertain outlook for the equity markets, hedge funds should benefit from being flexible and adjusting their portfolio to include shorter term trading strategies. Following a period of great distress (2008) and a period of great opportunity (2009), hedge funds in 2010 should achieve returns much closer to their historical levels than those of the past several years. ■

REAL ESTATE: IS THE WORST BEHIND US?

Peter J. Rogers, CFA, Assistant Vice President

2009 Review

Commercial real estate continued to experience a significant downturn in 2009, exacerbated by excessive leverage and a severe economic recession. Property fundamentals continued to deteriorate sharply. Market vacancy rates have trended higher than historical averages across all four major property types, and even exceeded previous highs in several cases. Similarly, rents have remained under pressure despite declines of 15% or more in many markets.¹

At the end of the third quarter, the trailing four quarter total return for the NCREIF Property Index (NPI) was -22.1%, the lowest one year return in the history of the index. For the third quarter 2009, NPI reported a total return of -3.3%, comprised

**Fourth Quarter
2009**

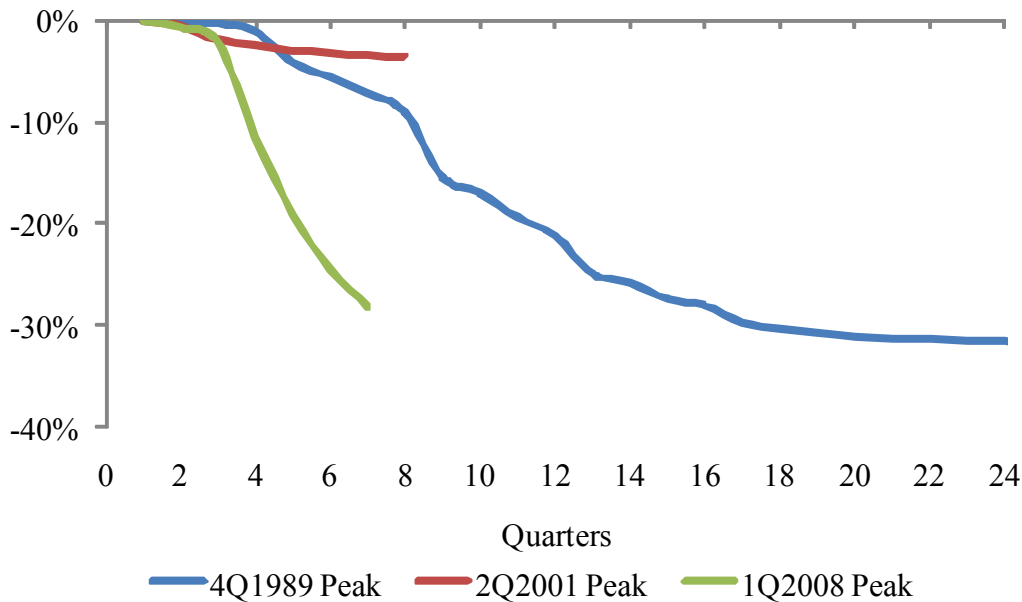
**M Marquette
Associates**
Integrity ♦ Diligence
Solutions

“Market vacancy rates have trended higher than historical averages across all four major property types, and even exceeded previous highs in several cases.”

Continued from page 18

of a +1.6% income component and a -4.9% appreciation component. This marked the sixth consecutive quarterly decline in appreciation since the market peaked in the first quarter of 2008. The current pace and magnitude of the write downs is proceeding more quickly than any previous downturn. Some of the reasons include a deeper recession, higher quality information (public markets, transaction price indices, and derivatives markets), increased transparency, and stricter accounting rules.²

NPI Cumulative Peak-to-Tough Value Declines



Source: NCREIF

As the chart above illustrates, NPI appreciation has declined by 28.3% in the last six quarters. In comparison, it took 15 quarters to experience equivalent write downs in the early 1990s, and that correction lasted six years. Despite the faster correction of the appraisal based NPI, the index still lags the transaction market by a considerable margin. Currently, there are two indices that track prices in the transaction market, MIT's Transaction Based Index (TBI) and Moody's/REAL CPPI. These indices reported price declines from their peak through the third quarter of 36.5% and 42.9% respectively. Further declines in the NPI are expected to continue as the lagging appraisal based index more accurately reflects recent transactions.

Pricing commercial real estate remains extremely challenging given the limited transaction activity and the overall distress in the market. Property owners are hesitant to sell when prices are severely depressed and banks are reluctant to foreclose. As the following graph illustrates, property sales through September are down 75% from 2008 and more than 90% from 2007 volume. However, transaction activity continues to improve and volume has increased in each of the last two quarters.

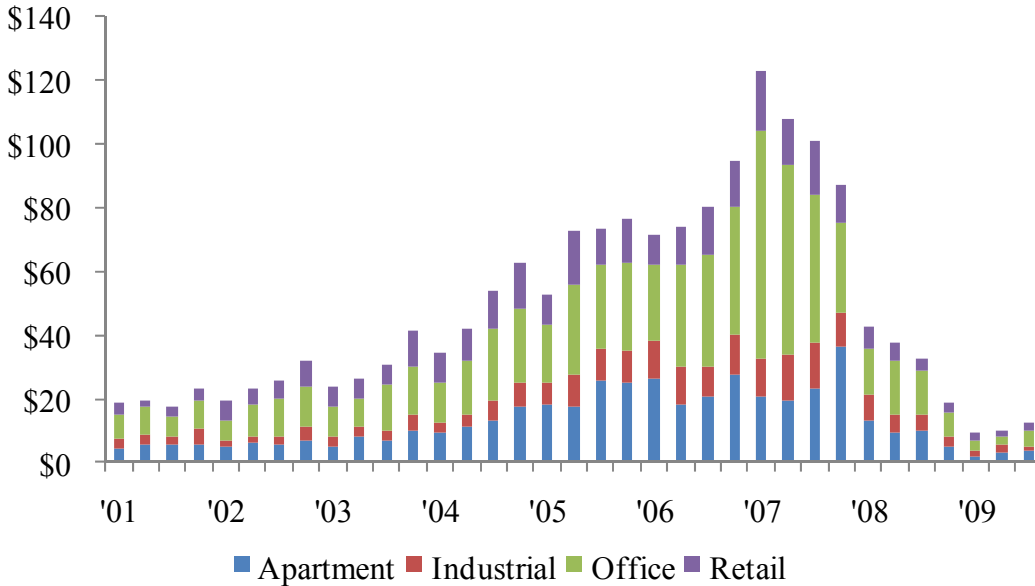
**Fourth Quarter
2009**

**M Marquette
Associates**

Integrity ♦ Diligence
Solutions

“Property owners are hesitant to sell when prices are severely depressed and banks are reluctant to foreclose.”

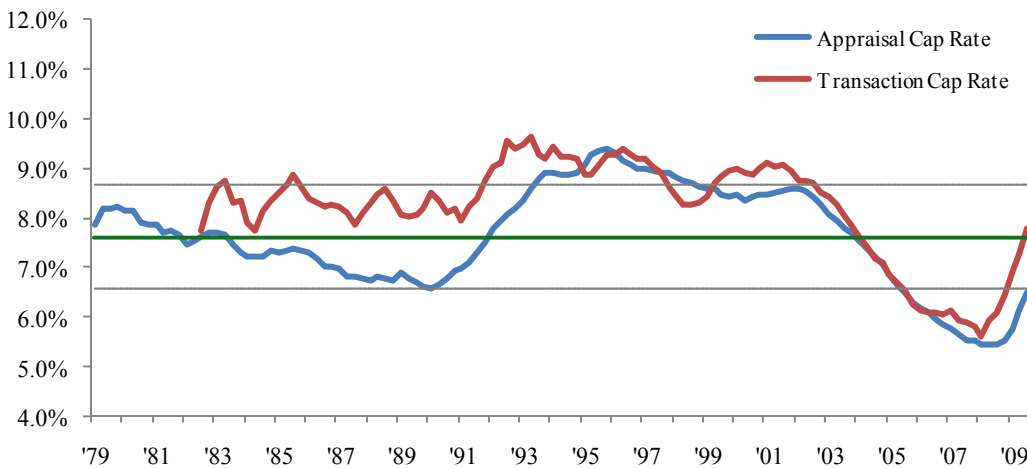
Commercial Real Estate Sales (Billions)



Source: Real Capital Analytics

Falling valuations and transactions prices are reflected in rising cap rates that are quickly reverting back toward their long-term averages. Average transaction cap rates, represented by the rolling four quarter moving average, have increased by approximately 220bps since establishing a low of 5.6% in the first quarter of 2008. The average transaction cap rate is now above the long-term average of 7.6%. The NPI average appraisal cap rates continue to lag the transaction market suggesting that further value declines in the index are forthcoming.

NPI Transaction and Appraisal Cap Rates



Source: NCREIF

**Fourth Quarter
2009**



“Asset value and operating income deterioration coupled with limited financing are placing significant stress on borrowers needing to refinance loans.”

Continued from page 20

As the chart reveals, one can see the significant cap rate compression that occurred from excessive leverage and easy credit that pushed cap rates to historical lows from 2005-2008. During this period cap rates fell well outside of the historical ranges represented by the band of the two gray bars above.

Credit markets for commercial real estate remain challenging. Asset value and operating income deterioration coupled with limited financing are placing significant stress on borrowers needing to refinance loans. A looming concern for the commercial real estate market is the refinancing of the vast amount of loans that were issued from 2005-2008. Approximately \$2.8 trillion of commercial mortgages were originated between 2005 and 2008; nearly double the \$1.5 trillion written during the previous four years.³

The lack of new financing has caused a “funding gap”, the difference between existing mortgages that will need to be refinanced and new originations. Prudential estimates that the size of this funding gap is between \$610 billion and \$825 billion. In other words, property owners will need either a capital infusion of equity, subordinate debt, and debt forgiveness/loan losses to recapitalize their maturing loans and fill this funding gap.⁴ A majority of the maturing loans in 2009 were simply extended by lenders, coining the term “pretend and extend”, as they hope the problem goes away before they are forced to foreclose on properties.

Where do we go from here? Navigating 2010

As we enter 2010, signs of broad U.S. economic improvement have emerged. However, fundamentals are likely to continue to be weak as demand for commercial real estate typically lags the general economy by 12-18 months. Past recessions indicate that several quarters of job growth may be required before we see improvements in metrics such as vacancy rates, rent growth and net operating incomes. The industry estimates peak-to-trough declines of approximately 40%-45% in this cycle before values begin to stabilize; many predict stabilization will occur over the next two or three quarters.

Unlike the previous downturns in commercial real estate, developers did not overbuild heading into the most recent peak. As a result, there is limited construction that will add to vacancy in the short-term. Furthermore, new construction projects will remain subdued as long as asset values remain well below replacement cost. Given the limited construction and the long lead time to deliver real estate projects, rental and vacancy rates could bounce back more rapidly as the market recovers.

While it may be a few quarters before we see prices stabilize in the commercial real estate market, it may be prudent to start evaluating potential opportunities. We believe that attractive investment opportunities will emerge for those investors that are properly positioned. For risk averse investors, 2010 will present opportunities

*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

“Given the limited construction and the long lead time to deliver real estate projects, rental and vacancy rates could bounce back more rapidly as the market recovers.”

Continued from page 21

to access high quality core funds at historically low valuations. At the other end of the spectrum, opportunities are emerging for more opportunistic investors looking to take advantage of the growing distress in the market. However, due diligence and research with an emphasis on risk management remains critical when evaluating any opportunity, most especially in real estate given the current environment. As more attractive investment opportunities emerge, real estate investors may finally have something to celebrate in 2010. ■

Sources:

¹TIAA-CREF Asset Management, *Real Estate Investment Quarterly Highlights, Third Quarter 2009*.

²LaSalle Investment Management Research & Strategy, *NCREIF 3Q2009 Summary*

³Prudential Real Estate Investors, *Life After Debt: Coming to Grips with the Funding Gap, September 2009*.

⁴Prudential Real Estate Investors, *U.S. Quarterly Market Perspective, October 2009*.

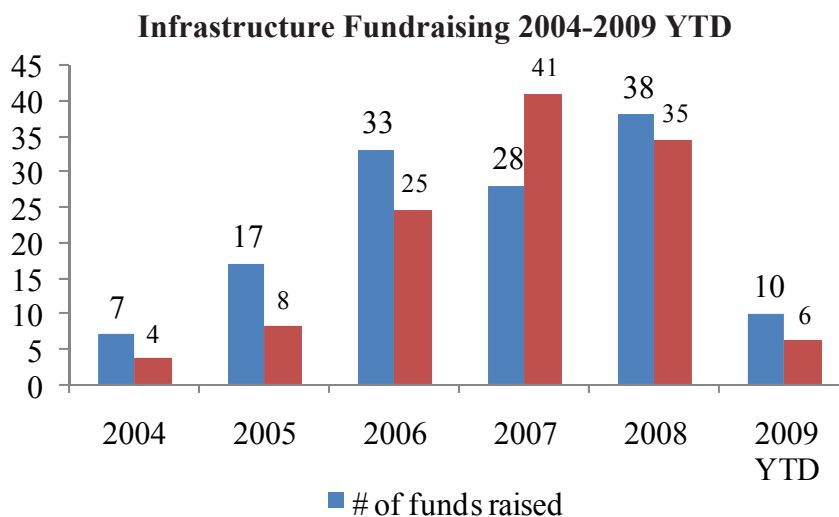
INFRASTRUCTURE: PROCEED WITH CAUTION

Peter J. Rogers, CFA, Assistant Vice President

The global economic recession and credit market turmoil has illustrated that infrastructure investing is not immune from economic and financial shocks. Early investors in infrastructure watched as this relatively new asset class was tested throughout the financial crisis like never before. Furthermore, investors' perception of infrastructure was challenged as they experienced significant more volatility than they may have expected.

Fundraising:

Investment in infrastructure funds saw dramatic growth from 2004-2007. Not surprisingly, infrastructure fundraising declined significantly in 2009, along with all illiquid alternative asset classes. According to Preqin, only 10 infrastructure funds reached a final close in 2009, raising an aggregate \$6.2 billion. This represents an 82% decline from the total capital raised in 2008 and an 85% drop from 2007 totals.



Source: Preqin, *Infrastructure Spotlight, December 2009*.

**Fourth Quarter
2009**

**M Marquette
Associates**

Integrity ♦ Diligence
Solutions

“An increasing number of managers have extended their fundraising periods leading to an abundance of funds in the market raising capital.”

The scarcity of investor capital has led to the majority of fund managers struggling to achieve their fund raising targets. An increasing number of managers have extended their fundraising periods leading to an abundance of funds in the market raising capital. As of December 2009, Preqin estimates that there are approximately 116 funds in the market seeking to raise \$116.5 billion. In the U.S. alone there are 23 funds seeking an aggregate \$44.3 billion.

Performance and volatility:

Institutional investors' interest in infrastructure is abundantly clear; one merely needs to look at the growth of this market over the last five years. Investors in infrastructure continue to be attracted to the underlying characteristics offered by investment in this asset class:

- High Barriers to entry/often monopolistic
- Low-volatility of cash flows
- Long-term, relatively stable yield
- Inflation protection
- Low exposure to changes in the business cycle
- Low correlation to other asset classes

However, as the global economic contraction unfolded, some began to question the validity of these characteristics as they experienced far more volatility than expected. Further analysis of the performance of various infrastructure funds reveals some insights into this volatility.

The significant growth of investor capital, abundant supply of cheap financing, and limited supply of suitable investments heightened competition over the last few years, ultimately driving up prices. The intense competition was further exacerbated by growing pressure to win deals in order to validate their experience and investment process to potential investors. Many fund managers participated in highly competitive auctions for “trophy” assets where they would either lose out to one of their competitors or face the risk of overpaying for the asset, as the winner was typically the one with the highest bid. As was the case in many other alternative asset classes, the availability of an abundant supply of cheap credit led to high levels of gearing or inappropriate financing structures in some cases.

As one can see, many of these insights are the direct result of the managers' decisions and are not necessarily reflective of the performance of the underlying asset.

2010 Preview:

The aftermath of the global economic downturn has produced a diverse set of potential investment opportunities over the short, medium, and long-term. While this set is not all encompassing it provides some recent examples of the sources of potential opportunities.

“Many fund managers participated in highly competitive auctions for ‘trophy’ assets .”

Fiscal pressure on governments – Federal, state and municipal governments worldwide are facing significant fiscal pressure, which was only exacerbated by the global economic downturn. Governments will increasingly rely on the private sector to meet the growing infrastructure funding gap.

- For FY 2010, the average state budget gap is expected to be 18%, with many states well above this level.¹
- According to the Center on Budget and Policy Priorities, 39 states have cut services this year in an attempt to balance their fiscal year 2010 budgets. At the same time, 30 states have enacted tax increases in an attempt to bridge budget gaps.
- In April, there was a Moody's report that assigned a negative outlook to US local governments, marking the first time the credit rating agency ever assigned such an outlook to an entire class of debt issuers according to Bloomberg.

Greenfield opportunities – The majority of these opportunities will emerge out of the government infrastructure spending stimulus. According to UBS, the combined fiscal easing will approach \$2.5 trillion, or just less than 4% of global GDP by 2010.² Of that amount, just over half or approximately \$1.3 trillion is dedicated to infrastructure.³

Corporate divestments and joint ventures capex projects – Decisions for corporations to divest assets may either be strategically or financially driven. Corporations may also seek joint venture partners as they look to reestablish their capital expenditures after halting most major spending.

Regulation – These opportunities are particularly seen within the European utilities sector. The European Commission is trying to unbundle the vertically integrated model within the energy sector and separate out energy production/generation and distribution assets. The renewable energy sector is also another source of opportunities, as the US and China in particular are incorporating regulatory support for the sector.

Distressed Sales – According to UBS, global listed infrastructure companies must refinance 27% of their net debt in 2009 and 2010.

While a diverse set of potential investment opportunities have emerged, investors must still proceed with caution. The growing landscape of fund managers coupled with the decline in recent deal activity has led to large amounts of capital outstanding. Competition for high quality core assets is anticipated to remain strong; however, the use of excessive leverage that caused rapid price appreciation across the private markets is no longer feasible.

*“The easy gains
of excessive lev-
erage and finan-
cial engineering
are over.”*

Continued from page 24

Going forward the most successful fund managers will not only maintain price discipline when acquiring assets, but will also have active asset management capabilities to extract value. The easy gains of excessive leverage and financial engineering are over. Increased scrutiny of fund managers is required, with specific emphasis on better alignment of interests and operational expertise. The ability to source active deals off market remains an important element in the selection of fund managers. ■

Sources:

¹Center on Budget and Policy Priorities.

²UBS, *Outlook for global infrastructure, October 2009.*

³Colonial First State *Global Asset Management, The changing global infrastructure investment landscape, September 2009.*

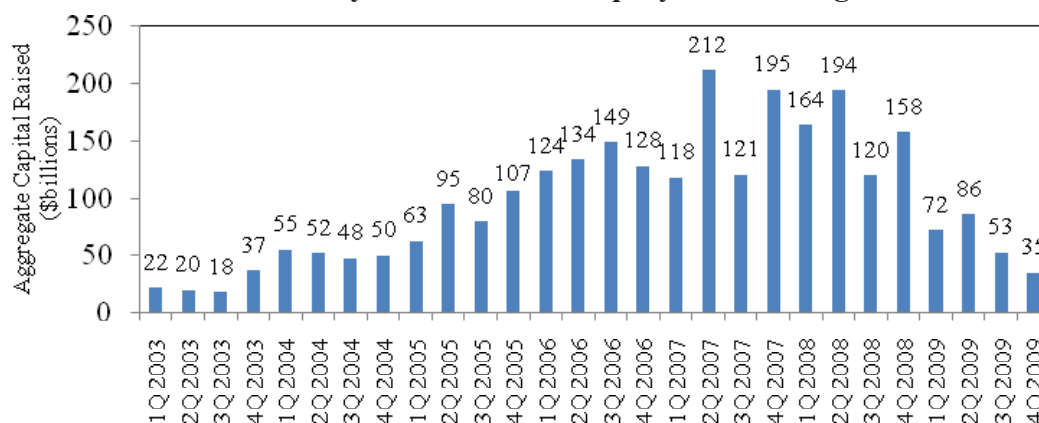
PRIVATE EQUITY: AN IMPROVING OUTLOOK

James R. Wesner, CFA, Vice President

The private equity market remained sluggish for the majority of 2009, but signs of increased market activity are beginning to appear. Private markets are continuing to work off a hangover from the large volume of overpriced and overleveraged deals that took place from 2005 through 2007. The markets now face the prospect of working through transactions completed during this period of excess and funds from these vintage years will struggle to meet return expectations.

In addition to dealing with the transactions that were completed in previous years, the 2009 fundraising market also had to cope with the glut of uninvested fundraising dollars from 2008. With General Partners (GPs) unable to find suitable investments during the past 18 months, the amount of dry powder remains high. 2009 saw fundraising volume drop back to 2004 levels, a greater than 60% decline from the peak in 2007.

Quarterly Global Private Equity Fundraising¹



Limited Partners (LPs) are in a much clearer position now than the start of 2009, but most remain cautious on additional commitments to private equity. Although adjustments in private equity valuations and the recovery in the public markets have combined to alleviate the denominator effect, many LPs have fundamentally altered their views of the private equity asset class.

**Fourth Quarter
2009**

**M Marquette
Associates**

**Integrity ♦ Diligence
Solutions**

*“...Global PE
fundraising has
dropped back to
2004 levels.”*

Continued from page 25

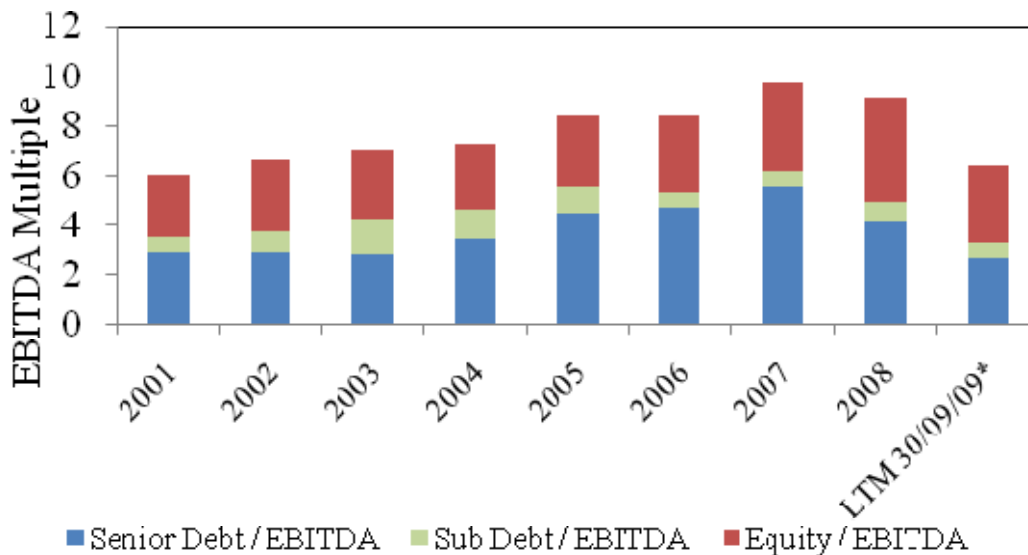
One important factor helping to reignite private equity transactions has been the thawing of the credit markets. Even though credit spreads contracted significantly during 2009, financing is only available at moderate levels. Leverage multiples continue to contract for transactions, as do purchase price multiples. Both of these factors will likely help provide for strong vintage year returns for private equity in the coming years.

**Fourth Quarter
2009**

**M Marquette
Associates**

Integrity ♦ Diligence
Solutions

Average Purchase Price Multiple Large Buyout²



“...both dollars transacted and the number of deals closed have fallen significantly from the '07 highs.”

While the large deals are not dead, it will take time for the credit markets to completely heal and resume financing larger deals. In the meantime, transactions in the small and middle markets will continue to be executed. Deals will require higher amounts of equity and the reduction of the amount of debt that can be applied to the transactions will keep continued pressure on price multiples.

Decreased fundraising combined with decreased purchase price and leverage multiple have led to the sharp decline in investment activity for 2009, as transaction volume dropped by nearly 60%. While investment activity has continued at a slower pace, the end of the year saw signs of a leveling off and the possibility that a bottom to the market is near. Also, transaction volume for distressed deals (i.e. bankrupt companies) increased throughout the year and became a much higher percent of the overall private equity market.

With distress comes opportunity and there are certainly several potential areas for investment in private equity that could generate strong returns over the coming years. The areas of the private equity markets that received the warmest reception in 2009 were secondary opportunities, distressed and mezzanine strategies. While these strategies typically perform well coming out of a downturn, 2009 still proved to be a difficult market environment for putting capital to work in these strategies.

Continued from page 26

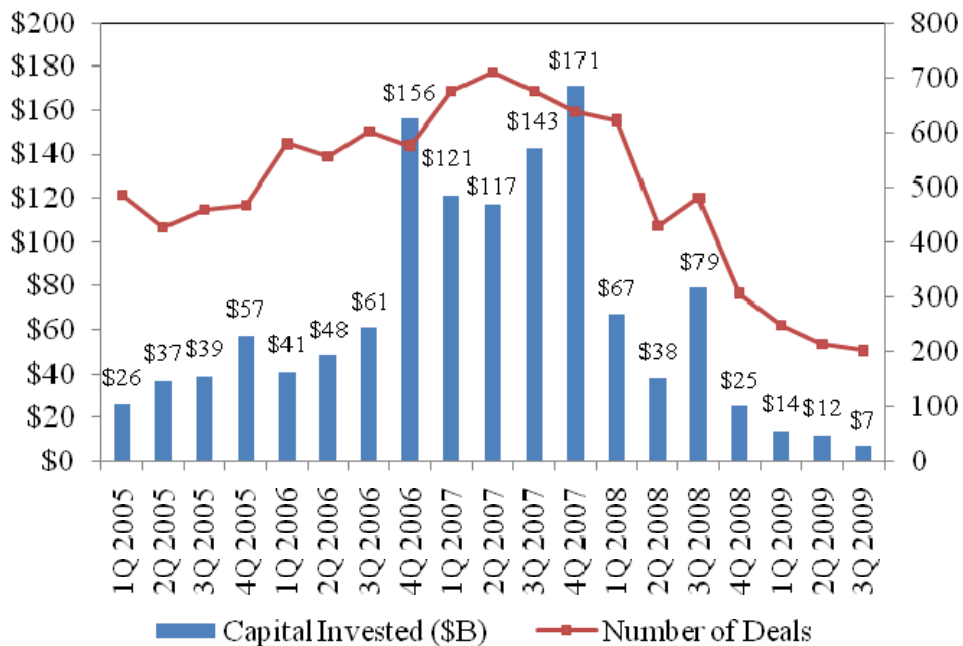
Transaction volume for secondaries, arguably the most popular private equity investment idea at the beginning of 2009, did not materialize as many expected as the bid/ask spread remained wide for much of the year. A leveling off of valuation declines should help more buyers and sellers come to agreements on secondary transactions in 2010.

*Fourth Quarter
2009*

M Marquette
Associates

Integrity ♦ Diligence
Solutions

Total Private Equity Deal Flow³



Against a backdrop of an equity market recovery and sluggish but improving macro-economic conditions, the outlook for private equity will improve as we move into 2010. Returns for vintage years following a recession typically present the best environment for investing. Those investors with fresh capital to deploy in this market will have the opportunity to take advantage of lower purchase price multiples and an improving exit environment in years to come. ■

Sources:

¹Preqin

²Standard & Poors

³PitchBook

*Fourth Quarter
2009*



M Marquette
Associates

Integrity ♦ Diligence
Solutions

180 North LaSalle Street

Suite 3500

Chicago, IL 60601

312-527-5500

www.marquetteassociates.com

The sources of information used in this report are believed to be reliable. Marquette has not independently verified all of the information and its accuracy cannot be guaranteed. Opinions, estimates, projections and comments on financial market trends constitute our judgment and are subject to change without notice. References to specific securities are for illustrative purposes only and do not constitute recommendations. Past performance does not guarantee future results.

Four Points Multi-Strategy

FIRM OVERVIEW

Shenkman Capital Management, Inc. ("SCM") is an independent investment management organization, founded and registered as an investment adviser with the SEC in July 1985. Over the past 24 years, SCM has dedicated its investment management services exclusively to the leveraged finance market, earning a reputation as a pioneer in the asset class as well as an early practitioner of credit research analytics. SCM manages approximately \$10 billion of assets for a predominately institutional client base, with offices in New York, NY, Stamford, CT, and London, UK.

INVESTMENT PHILOSOPHY

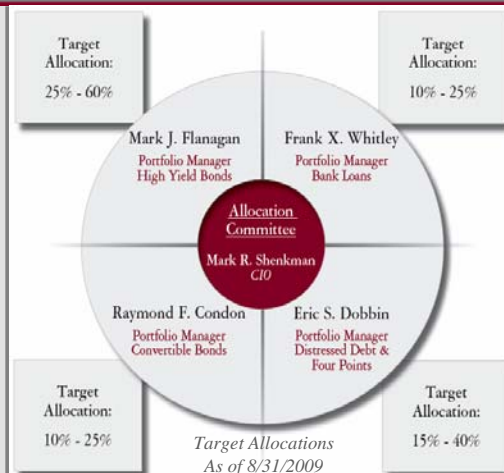
SCM provides a conservative and prudent approach to investing in high yield that seeks to maximize risk-adjusted performance over a full market cycle. All SCM investment strategies are based upon rigorous, proprietary credit analysis that seeks to invest in companies with strong and/or improving financial characteristics, while avoiding those most likely to default. The primary objective is to preserve capital during all market environments by mitigating credit risk and avoiding defaults.

STRATEGY OVERVIEW

SCM's Four Points Multi-Strategy offers a unique exposure to the \$2.5 trillion levered credit markets utilizing SCM's core competencies: conservative approach and rigorous, bottom-up, fundamental research process. The strategy applies the philosophy, strategy, and proprietary analytical tools of all four product offerings (bonds, bank loans, convertible bonds, and distressed) in one diversified portfolio. The dynamic nature of the portfolio's asset allocation process enables the Portfolio Manager to adjust to changing market conditions in order to capitalize on prevailing relative value opportunities across the capital structure.

PRODUCT SUMMARY

- ❖ Tactically allocate capital across the capital structure based on prevailing relative value (senior secured loans, subordinated bonds, convertibles, ect.).
- ❖ Allocation Committee determines relative value – Consists of CIO and Product Portfolio Managers.
- ❖ Mark Shenkman serves as Chief Investment Officer – Establishes macro policy which sets the foundation for capital structure positioning.
- ❖ Allocation Committee meets at least monthly to debate relative value and asset allocation.
- ❖ Product Portfolio Managers invest the portion of the Fund's assets allocated to their strategy.
- ❖ Eric Dobbin serves as the Portfolio Manager for the Four Points Multi-Strategy product and oversees product positioning and risk management.



SHENKMAN CAPITAL MANAGEMENT, INC.

262 HARBOR DRIVE, 4TH FLOOR
STAMFORD, CONNECTICUT 06902
(203) 348-3500

461 FIFTH AVENUE, 22ND FLOOR
NEW YORK, NEW YORK 10017
(212) 867-9090

SHENKMAN CAPITAL MANAGEMENT LTD

7 CLIFFORD STREET
LONDON UK W1S 2FT
+44 (0) 20 3371 8234

September 30, 2009

PROPRIETARY CREDIT RESEARCH TOOL

C. SCOPE® Score

0-5 Point Scale
Blend of Both Quantitative & Subjective Elements
Equally Weighted

Scoring

- Maximum Score of 125 credit points
- Identify investments with a score typically 70 or above
- Quarterly rescoring

Elements Analyzed

1. Financial Characteristics
2. Management/Industry Fundamentals
3. Critical Trading Issues

DISCIPLINED INVESTMENT INVESTMENT PROCESS

- i Analytics/Research Report
- ii Credit Committee
- iii Secret Ballot Vote
- iv "Approved List"
- v Portfolio Construction Process
- vi Monitoring/Risk Management
- vii Regular Review & Attribution
- viii Rules Based Sell Discipline

FOR MORE INFORMATION PLEASE CONTACT:

SHENKMAN CAPITAL MARKETING DEPARTMENT

Nicholas G. Keyes, CFA, CAIA
Senior Vice President
Director of Business Development

Tel: (203) 348-3500
Fax: (203) 348-3508

marketing@shenkmancapital.com
www.shenkmancapital.com