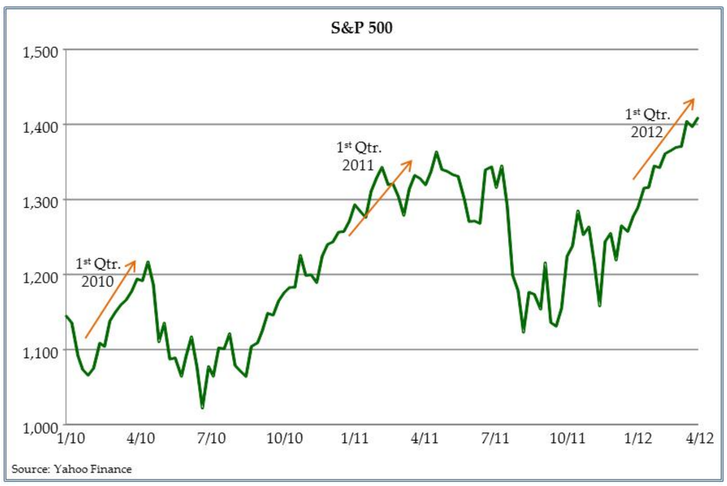
CAPITAL MARKETS UPDATE

Full-fledged optimism was hard to find, but investors were encouraged by signs the US economy is improving as well as new liquidity measures in the Eurozone and embraced risky assets in the first quarter. Within equities, financials and technology shares helped the US outperform both international and emerging markets, as the S&P 500 rose 12.6% and the Russell 2000 returned 12.7%. Is this first quarter rally déjà vu all over again? Some market analysts think so and are speculating that 2012 will be the third year in a row that a mid-year swoon wipes out early gains. Still others point to the improved unemployment picture in the US, a more comprehensive solution for the Eurozone and a likely soft landing of China's economy as evidence that the 6 month old rally may indeed be fundamentally sound and sustainable.

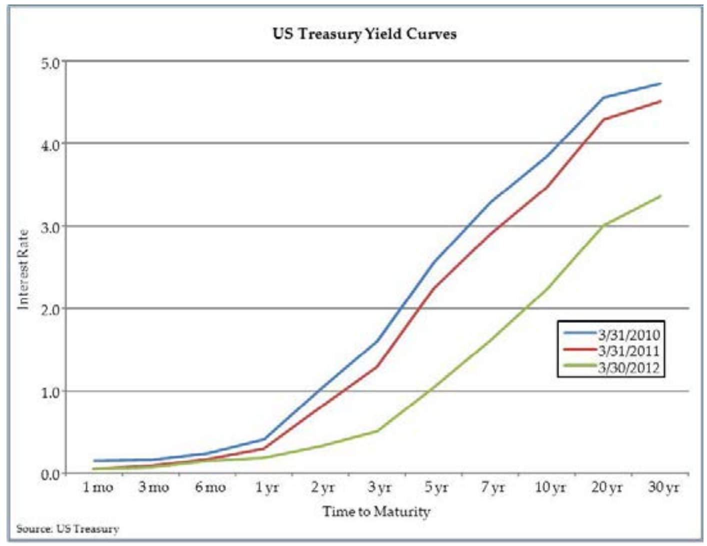


Among other volatile asset classes, real estate continued to rally (+10.8%), while commodities posted a modest gain (+0.9%).

Fixed income returns were muted by a dramatic rise in both short and longer term Treasury bond yields. The 10 year Treasury yield was up 19% (from 1.87% to 2.22%) for the quarter, but remains 36% lower than one year ago (3.46%).

BOND YIELDS REVISITED

Last quarter we suggested that the path of least resistance for US Treasury securities seemed to be flat/reduced demand in the face of growing supply, which would result in flat or rising yields. The supply side of the issue is fairly easy to understand – the federal government borrows (issues new bonds) to fund deficit spending. Understanding demand is a bit more complex, but interest rates can provide some insight into long-term market expectations. Perhaps the most informative place to look is a yield curve. In finance, the yield curve represents the relationship between the interest rate (or cost of borrowing) and the time to maturity (or "term") of the debt for a given borrower in a given currency. For example, the US dollar interest rates paid on US Treasury securities for available maturities on any given day can be plotted on a graph such as the one below.



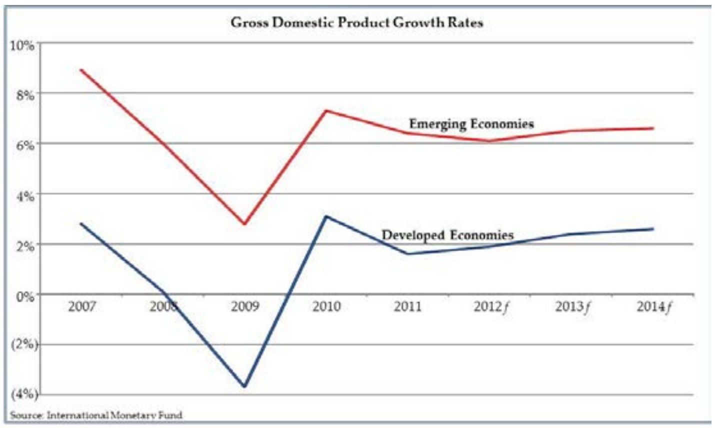
Over the past 25 years, by far the most common shape of the yield curve has been upward sloping, meaning that yields rise as the maturity of the security lengthens. An upward sloping yield curve also compensates investors for bearing inflation risk and suggests that financial markets expect short-term interest rates to rise in the future. The existence of an upward sloping yield curve makes sense today because short-term interest rates are already at or near historical lows.

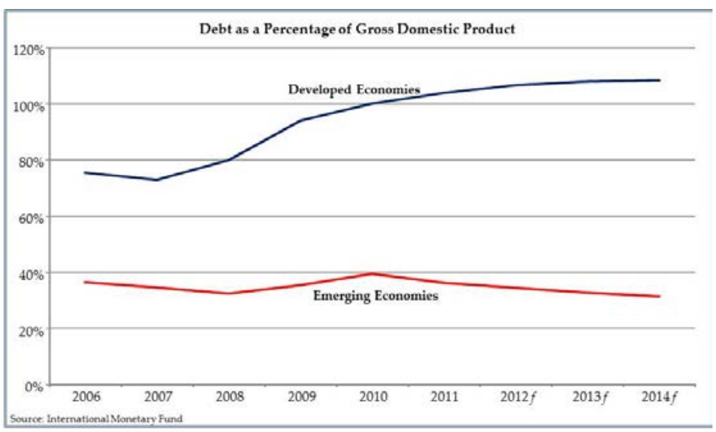
In addition to the slope of the yield curve, we also are interested in changes or shifts in the yield curve over time. The consistent downward shift in the yield curve from the 1st quarter of 2010 to today most likely reflects three things:

- First and foremost, extraordinarily loose and accommodating monetary policy focused on reducing rates to promote leverage and growth
- Expectations that loose monetary and fiscal policy will not result in high inflation
- Lower expectations for growth over the period

INVESTING IN A MULTI-SPEED WORLD

The US Treasury yield curve supports the "New Normal" viewpoint that developed economies (US, Eurozone, Japan, UK, etc.) will face sluggish growth (2-3%) for the foreseeable future. Emerging economies (China, Russia, India, Brazil, Mexico, etc.), on the other hand, are likely to experience higher growth rates (6-7%) while battling inflationary concerns. The reasons for this divergence illustrated below are twofold: Government Debt & Deficits and Demographics.





Government Debt & Deficits

Prior to 2008, developed economies took advantage of low borrowing rates to dramatically expand their private and public sector debt levels. Debt levels swelled further as measures were taken in 2008–2009 to avoid a global depression and normalize capital markets. Since then, deficit spending in the US and Europe's willingness to use over €1 trillion to bail out peripheral economies and stabilize the region has pushed public debt to unsustainable levels in some countries. Meanwhile, emerging economies weathered the financial crisis far better and are on pace to return public debt to pre-crisis levels over the next few years.

From an investment perspective, stronger balance sheets and 3-4% higher yields make emerging market sovereign bonds a compelling alternative to their developed counterparts.

Demographics

Developed economies are also faced with aging workforces and low birth rates. Fewer young workers to replace and support the entitlement programs of those retiring will be particularly punitive from a growth perspective. Conversely, basic demographics are the biggest driver of expansion in emerging market economies. Explosive population growth and the subsequent rise of a robust, savings-oriented middle class are rapidly transforming the global economic landscape.

Going forward, emerging markets remain likely to outpace growth in the developed world as capital continues to pour into these economies in an effort to take advantage of the younger, less expensive workforce and a booming consumer base.

IMPLICATIONS FOR INVESTORS

Global investing has been a part of our investment process from the beginning and because of their shifting role in global finance, emerging markets will likely continue to gain a more prominent role in investor portfolios going forward. Nevertheless, it's important to keep three guiding principles in mind: 1) Over the long haul and through market cycles, rational rather than emotional decisions underpin a sound and successful investment strategy 2) Asset allocation should be aligned with our risk tolerance and our financial objectives 3) Broad, global diversification, disciplined rebalancing and tax-wise, cost-conscious investing will best enable success in reaching our financial goals.