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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

CALENDAR YEAR 2011 IN REVIEW

January 2012

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Calendar Year 2011 in Review

Investment Strategy & Manager Research Teams

Global equity markets generally posted sizable losses in 2011—with the notable exception of the United States—as the deepening European debt crisis dragged returns down worldwide, while major developed bond markets (e.g., the United States, the United Kingdom, and Germany) posted blockbuster returns.

Developed Markets Equities

Global

- The MSCI World Index returned -5.5% in 2011, although returns were much worse prior to a 10%+ boost in October.[1]

- Economic sector returns were mixed, with four up and six down. Health care (9.5%) and consumer staples (8.6%) were by far the best performers, as defensive areas generally bested cyclical sectors such as materials (-19.8%), financials (-18.5%), and industrials (-8.2%).

- All major developed regions posted negative returns save the United States (1.4%), which benefitted as investors sought *relative* safe havens amid the market volatility. Outside the United States, returns ranged from -1.8% (United Kingdom) to -18.7% (Japan). Individual country returns were poor as well, with every country in the red but three—Ireland, New Zealand, and the United States—and 15 posting losses of at least 10%.

- Global ex U.S. large caps beat small caps by more than 4 percentage points—their first year of outperformance since 2008—while growth and value were essentially tied. Still, growth has topped value by more than 8 percentage points over the past two years.

- Currency fluctuations cut both ways, as the U.S. dollar rose 3.3% against the euro and 2.4% against the Canadian dollar, but fell 5.1% against the yen and was essentially flat against other developed markets currencies. As a result, local currency and US$ returns for the MSCI World Index were nearly identical.

United States

- After two consecutive years of blockbuster returns, U.S. equities returned 2.1% in 2011, with the entire performance attributable to dividends alone—the S&P 500 Index actually ended the year at the same price as at the end of 2010. Of course, the year was filled with many ups and downs—the S&P returned 9.1% from January 1 through April 29, -18.6% from May 2 through October 3, and 15.1% through the end of the year.

- The S&P 500 Index also trounced the MSCI World ex U.S. Index for the second consecutive year (in US$ terms only), topping non-U.S. developed markets by 14 percentage points in both local currency and US$ terms for 2011. Meanwhile, U.S. equities outperformed emerging markets equities in local currency terms by a similar margin, but bested the asset class by more than 20 percentage points in US$ terms, as the greenback strengthened against 18 of the 21 emerging markets currencies we track.

[1] All returns represent total returns in local currency terms unless otherwise noted.

- A majority (seven out of ten) of the S&P 500 economic sectors finished the year in the black, with utilities (19.9%), consumer staples (14.0%), and health care (12.7%) leading the way, while laggard financials (-17.1%) trailed the next weakest sector (materials) by more than 7 percentage points.

- Growth bested value for the third consecutive year, during which time it has outperformed by more than 20 percentage points (measured by the Russell 3000® Growth and Value indices). Mega caps also outperformed, as the Russell Top 50® Index and Russell Top 200® Index returned 4.4% and 2.8%, respectively, compared to -4.2% for small caps. As a result, mega-cap growth (a high-quality proxy) was the best-performing style segment (4.6%).

Europe

- The MSCI Europe ex U.K. Index returned -12.9% for the year, as the metastasizing sovereign debt crisis threatened the very existence of the euro.

- As Eurozone banks found it increasingly difficult to fund themselves from the interbank market and money market funds, the European Central Bank (ECB) opened an unlimited three-year loan facility for Eurozone banks at year-end (with the Orwellian name Long-Term Refinancing Operation [LTRO]), raising the question of whether the ECB is supporting *liquidity* or *solvency*.

- Newly installed ECB president Mario Draghi cut rates twice, but said the ECB would not act as the lender of last resort to overindebted governments, although the LTRO seems to provide a very similar function.

- Ireland was the only European market in the black, as the country appears to be ahead of the austerity "curve." Greece did the worst (-61.5%) for obvious reasons.

- Non-Eurozone markets generally fared better, with the Zurich bourse, for example, benefitting from the introduction of a Swiss franc euro peg at the beginning of September, while Norway returned "only" 7.6%.

- The United Kingdom, meanwhile, did the best among major European markets, as U.K. banks suffered less damage than continental banks, and the country was viewed as a relative safe haven.

- Sector performance was bifurcated, with defensives doing well while cyclical sectors and financials lagged. In Europe ex U.K., financials returned -25.9% and health care, 9.4%, while in the United Kingdom, basic materials returned -27.5% and health care, 18.7%.

Japan

- After a strong January and February, Japanese equities were hammered by the March earthquake/tsunami and, subsequently, global sovereign debt and economic growth fears. The MSCI Japan Index returned -18.7%—the worst among major markets—more than wiping out its 9.7% return from 2009 and 2010.

- Returns in US$ (-14.3%) and GBP (-13.7%) were somewhat better, and US$ returns are still positive over the last three years.

- Consumer staples (3.0%) was the only sector in the black, while utilities (-42.5%) did the worst for the second straight year. Information technology (-25.1%) and financials (-24.6%) were notable laggards.

- The MSCI Japan Small Cap Index returned -8.8%, as smaller capitalization stocks outperformed significantly for the second consecutive year, while value (-18.0%) and growth (-19.5%) both did poorly.

Asia ex Japan

- The MSCI All Country Asia ex Japan Index returned -14.6% in 2011, while unhedged US$ investors did even worse (-17.1%).

- India (-25.4%), China (-18.3%), and Taiwan (-17.1%) were notable laggards, while Indonesia (7.2%) was easily the best performer; Thailand, Malaysia, and the Philippines also nudged into the black.

- Singapore (-17.0%) and Hong Kong (-16.1%) slightly underperformed the broad index, while Australia and New Zealand—which are not in the Asia ex Japan index—returned -11.0 % and 5.7%, respectively. Returns were similar in US$ terms. New Zealand was the second-best performer among *all* developed MSCI markets.

- All sectors save telecommunications (8.9%) and consumer staples (2.9%) were in the red for the year, with higher-beta sectors such as industrials (-26.7%), materials (-20.7%), and financials (-20.2%) the worst performers.

Emerging Markets

Equities

- Emerging markets returned -12.5% for the year, lagging developed markets by a whopping 700 basis points (bps).

- However, emerging markets have still outperformed over the past three-, five-, and ten-year periods. Indeed, over the past decade, emerging markets have bested developed markets by an eye-rubbing 1,090 bps *a year*—12.6% to 1.7%.

- Emerging markets have returned roughly 97% from their 2008 low, and are 17% below their October 2007 high; developed markets, by contrast, have risen 70% from their 2009 low, and are 24% below their 2007 peak.

- Latin America returned -9.8% for the year, followed by Asia (-14.2%) and Europe and the Middle East (16.4%); 16 of 21 constituent markets were in the red.

- Eight of ten economic sectors were also in the red, with consumer staples (9.9%) and telecommunications (2.9%) the exceptions, while industrials (-25.3%) and materials (-20.3%) lagged.

Debt

- US$-denominated emerging markets bonds returned 7.3% for 2011, their third consecutive year in the black. Emerging markets bond yields ticked lower by 12 bps, while spreads over ten-year U.S. Treasuries widened 129 bps, to 395 bps, as Treasury yields fell 141 bps.

- Local currency debt also performed well, although gains were wiped out for unhedged US$ investors—the J.P. Morgan Government Bond Index Emerging Markets Global Diversified returned 8.4% in local currency and -1.8% in US$ terms.

- Since its January 1994 inception date, the J.P. Morgan Emerging Markets Bond Index Global has returned a bang-up 10.1% in US$ terms on an annualized basis, although current yields do not offer similar appreciation potential.

- The J.P. Morgan Emerging Local Markets Index Plus, which has an average maturity of approximately 60 days, returned 2.7% (-5.2% in US$ terms) for the year. The index yield over six-month Treasuries (342 bps), meanwhile, remains well below its historical average of 792 bps.

Fixed Income

Global

- The J.P. Morgan Global Government Bond Index returned 6.3% in local currency terms for 2011, and 7.2% for unhedged US$ investors.

- The U.S. sovereign yield curve flattened by more than 100 bps, while yield curves in the United Kingdom and Germany steepened a bit.

- Central banks in the United States, the United Kingdom, and Japan stood pat on interest rate policy, while the ECB boosted rates in July and then cut them in November.

- Global corporate bond spreads widened appreciably, but this was almost entirely due to falling sovereign bond yields.

United States

- The Barclays Capital Aggregate Bond Index returned 7.9%, with all subindices (credit, government, and mortgages) in the black.

- The Federal Reserve concluded its $600 billion "QE2" program in June, then embarked on "Operation Twist," in which it sells short debt and buys longer-dated issues. The Barclays Capital Long-Term Treasury Bond Index returned nearly 30% for the year, with 30-year bonds now yielding just 2.9%.

- U.S. bond mutual funds saw an estimated total net inflow of roughly $130 billion during 2011, down from 2010's frantic pace. Municipal bond funds, meanwhile, saw an estimated approximately $10 billion net *outflow* for the year.

- Treasury securities returned 9.8% for 2011 as yields fell across the yield curve, with the benchmark ten-year yield falling 141 bps to just 1.9%. Yields for all maturities inside of five years are now below 1%, and the yield of even the 30-year bond is below the long-term historical rate of U.S. inflation.

- Investment-grade corporate bonds returned 8.1% for the year. The option-adjusted spread (OAS) of the Barclays Capital Corporate Investment Grade Bond Index widened 78 bps to 234 bps, but all due to falling Treasury yields.

- High-yield bond OASs widened nearly 175 bps during the year to nearly 700 bps, and yields rose from 7.5% to 8.4%; still, the Barclays Capital U.S. Corporate High Yield Bond Index returned 5.0%. The default rate for speculative-grade issues tracked by Moody's was just 1.8% for 2011, versus 3.4% in 2010 and 13.9% in 2009.

- The Barclays Capital U.S. TIPS Index returned 13.6% for the year, and real yields out to ten years are now negative. The ten-year breakeven level of inflation ended the year at 2.0%, down from 2.3% a year earlier. The U.S. CPI rose 3.4% during the 12 months ended November 31.

- The Barclays Capital Municipal Bond Index returned 10.7% in 2011, compared to 2.4% in 2010. Performance was driven by the plunge in underlying Treasury yields, as ratios of municipal yields relative to Treasury yields actually rose.

- Despite bleak forecasts and deteriorating fundamentals, defaults actually *fell* in 2011, from 0.1% in 2010 to 0.05%, due to a combination of state-mandated safeguards, financial incentives, and legal barriers that discourage default in most instances.

- Across strategies, longer-dated tax-exempts outperformed given the rally in interest rates, with the Barclays Capital 20-year index returning 14.0%, while lower-quality municipals lagged (9.2%).

Europe

- European investment-grade bonds returned 5.5% for the year, with government-related sectors besting corporate bonds, in part because the European corporate market is tilted heavily to financial issuers.

- German ten-year bund yields dropped more than 100 bps to 1.8%, while three-year yields swung wildly—a victim of ECB policy rate schizophrenia—and ended the year at just 29 bps.

- Italy, which saw government bond rates rise above 7% in 2011, faces the formidable challenge of issuing up to €240 billion in new debt in 2012.

- Euro-denominated inflation-linked bonds lagged other inflation-linked issues in 2011, although this was primarily due to toxic Italian linkers. U.K. linkers returned 20.3%, their best calendar year since the 1997 inception of the Barclays Capital index.

- Euro- and sterling-denominated investment-grade corporate bond spreads blew out during 2011, mostly due to falling sovereign yields. The OAS of Barclays Capital Euro-Aggregate Corporate Index increased by 120 bps to end the year at 332 bps, while the yield increased by a more moderate 72 bps. Almost all of the yield increase came from strain within the financial sector—the yield for industrial issuers was essentially unchanged for the year.

Asia

- Japanese government bond (JGB) yields managed to fall a handful of bps during the year, going from diminutive to miniscule—ten-year JGBs ended the year below 1%. The J.P. Morgan Japan Government Bond Index returned 2.3%.

High-Yield Credits

High-Yield Bonds

- The Barclays Capital Global High Yield Index returned 3.1% in 2011, although its OAS widened more than 200 bps, to 719 bps, while its yield rose from 7.5% to 8.7%.

- The Moody's global speculative-grade default rate shrank by nearly half from last year, with only 1.7% of issuers defaulting in 2011.

- The OAS of US$ high-yield corporate bonds widened 173 bps to 699 bps, yet the sector returned 5.0% thanks to high coupon income.

- Issuance of U.S. high-yield bonds soared early in 2011, and for the year totaled $246 billion, versus $156 billion on average over the past ten years. Roughly 80% of total issuance took place before volatility picked up in early August.

Bank Debt Market

- Bank loan prices rose 1.5% in 2011, while secondary market spreads ended the year at Libor plus 736, well above their July trough of Libor plus 570. Loan market fundamentals have been steady, despite periodic mutual fund outflows and selling by stressed global financial institutions.

- Defaults remain near record lows—the annualized default rate, in US$ terms, is 0.4%, and defaults totaled only $2.4 billion for the year.

- New institutional loan issuance was $229 billion, a near-50% increase over 2010.

- Inflows totaled $14.3 billion, with higher-quality BB paper a safe haven for buyers such as banks and insurance companies.

Non-Agency Mortgages

- Non-Agency mortgages generally had a poor year, with most segments of the market posting declines, as periodic rallies were quickly snuffed out by relentlessly poor fundamentals—e.g., high inventory of defaulted or foreclosed properties.

- The federal government stopped buying mortgage-backed securities, and actually began selling some of its vast holdings.

- The Fed published a white paper calling for more government intervention in the housing market, despite the failure of myriad similar programs.

- On the positive side, mortgage-backed securities prices in many cases discount extraordinary conditions unlikely to materialize, particularly over the potentially short lifespan of more seasoned securities, and may thus represent attractive opportunities for nimble investors.

Currencies

- The past year was a volatile one for currencies—broadly speaking, the U.S. dollar was weak for the first seven months or so as risk assets rallied, then strengthened as the Eurozone debt crisis came back into focus and investors sought safe havens.

- For the year, the U.S. dollar rose 3.3% against the euro and 2.4% against the Canadian dollar, but fell 5.1% against the yen and was essentially flat against the British pound, the Australian dollar, and the Swiss franc, resulting in flat performance overall.

- The euro fell 3.2% against the U.S. dollar, 3.0% against the Swiss franc, and 2.5% against the British pound. Still, the euro was remarkably resilient in 2011 given that the sovereign debt crisis escalated to the point of genuine possibility of a Eurozone breakup; while the euro fell some 13% against the U.S. dollar from its 2011 peak, it remains well above its 2010 trough of 1.19 EUR/USD.

- The U.K. pound was relatively weak against the U.S. dollar (falling 0.7% for the year), but strong against the euro (up 2.6%), partly due to safe-haven inflows from Europe.

- The Japanese yen was the best-performing currency we track (developed or emerging), rising 5.4% against the U.S. dollar, 6.2% against the British pound, and 8.9% against the euro. The yen finished the year at near-record highs versus the U.S. dollar at 77 USD/JPY, despite a surprise intervention by the Bank of Japan in late October.

- The Swiss franc soared through early August—up 21% against the euro and 30% against the U.S. dollar, reaching record highs versus both currencies—as the euro crisis prompted capital flight into Switzerland. As a result, the Swiss National Bank announced in September it would defend a floor of 1.20 versus the euro, causing the franc to fall some 20% and 15% against the U.S. dollar and euro, respectively.

- The Australian dollar had another wild ride in 2011. The Aussie dollar rose to a post-1982 high of 1.10 AUD/USD in July, then tumbled 12% over August and September. The currency then jumped 9% in October, fell a similar amount during November, and finally stabilized in December to finish flat for the year.

- Emerging markets currencies were hit hard in late 2011 after rising earlier in the year. For the year, an equal-weighted basket of 20 currencies fell 6.5% against the U.S. dollar, with a 7.8% decline in September alone, as investors abruptly reassessed the outlook for emerging markets amid the escalation in the Eurozone crisis. Currency weakness shaved off 5.7 percentage points, 5.1 percentage points, and 3.0 percentage points from emerging markets equity returns for unhedged US$-based, sterling-based, and euro-based investors, respectively, for the year.[2]

Hedge Funds

- The Hedge Fund Research Fund Weighted Composite Index fell by 5.0% for the year, badly lagging the S&P 500 (2.1%) due in large part to its 6.7% drop in the third quarter—the fourth-worst quarter in its 22-year history.

- Asset inflows pushed industry assets to a record $2.04 trillion as of June 30. There are now an estimated 7,500 hedge funds—nearly 9,500 when including funds of funds—the largest number since the 2007 peak.

- Equity long/short managers lamented the record high levels of inter-stock correlations in 2011, as well as the increased popularity of exchange-traded funds, high-frequency trading, and remaining scars from 2008, which have led to a "risk-on/risk-off" mentality that has been difficult for many managers to navigate. Some observers, meanwhile, have begun to broadly question the viability of long/short in light of recent poor returns.

- Global macro managers had an eventful year, with widely dispersed returns. Not surprisingly, those that timed the risk-on/risk-off environment successfully tended to perform the best.

- Distressed opportunities were limited, as the default rate remained low and many companies were able to roll debt maturities forward thanks to wide open capital markets during the first half of the year. Many managers expect a more robust opportunity set in 2012, as markets have tightened in recent months. Funds that held post-reorganization equities were punished in the third quarter, as many such equities suffered massive dislocations.

Commodities

- The diversified Dow Jones-UBS Commodity Index returned -13.3% for the year, while the energy-heavy S&P GSCI™ index returned -1.2%. Spot price returns for the two indices were -8.1% and 2.1% respectively, and roll returns, -5.2% and -3.4%.

- The roll return of the Dow Jones index was the least-punitive annual toll since 2004. Over the last five years—boom times for commodities—Dow Jones spot prices have appreciated at a brisk 7.9% compound annual rate, yet futures-based total returns were -2.1% on an annualized basis.

[2] Based on the MSCI Emerging Markets Index.

- The 2011 performance discrepancy between the S&P GSCI™ and Dow Jones indices was largely due to the Dow Jones index's hefty weighting in industrial metals, grains, and natural gas—all of which performed poorly—and the inclusion of strong-performing Brent crude in the S&P GSCI™.

- Within the Dow Jones index, the precious-metals index was the only sub-index to post a positive return (4.6%).

- Crude oil prices as measured by the near-month West Texas Intermediate (WTI) crude contract increased 8.4% during the year, versus an 8.2% increase for Brent crude. Thanks to new oil & gas drilling technology, the United States is now swimming in natural gas, and near-month futures ended 2011 below $3.00 per MMBtu (the lowest prices since September 2009), down 29.9% year-over-year.

Natural Resources Equities

- Natural resource–related equities (as proxied by the MSCI World Natural Resources Index) returned -8.3% for the year in US$ terms, moderately better than the -13.3% return of the Dow Jones-UBS Commodities Index. While oil & gas shares were essentially flat, the MSCI World Metals and Mining Index returned -27.6% (in US$ terms).

- Valuation metrics for natural resources equities are mixed, but broadly speaking, the asset class is at the high end of fair value. The Shiller price-earnings ratio for the composite index is 15.6, versus a post-1982 average of 18.9, although clearly earnings have benefitted from the tailwind of sharply rising commodity prices.

Energy Master Limited Partnerships

- Energy-related master limited partnerships (MLPs) returned 13.9% in 2011, and the distribution yield of the Alerian MLP Index ticked down from 6.2% to 6.1%.

- Distributions grew by an estimated 5.4% for Morgan Stanley Research's coverage universe; the firm projects 7.1% distribution growth in 2012 and 6.3% growth in 2013.

- We believe MLPs are fairly valued. Distribution yields of 6.1% are below the 7.2% average yield level over the past ten years, while spreads over other income-oriented investments are above average.

Private Investments in Oil, Gas, and Other Energy

- The Cambridge Associates Energy Upstream & Royalties and Private Equity Energy Index generated average net internal rates of return for the one-, three-, five-, and ten-year periods ending September 30, 2011, of 14.2%, 6.0%, 10.5%, and 19.4%, respectively.

- Price volatility has been the norm during 2011, driven by uncertainty around the pace of future global economic growth.

- Crude oil prices (WTI) traded at $99/barrel at the end of December, and gained approximately 9% for the year. The long-term industry outlook remains bullish, particularly in nominal terms, as governments and central banks show little sign of reversing easy money policies, while politically driven supply concerns remain, particularly in Iran.

- Natural gas prices, as measured by the Henry Hub spot price, ended 2011 at $2.96 per MMBtu, down nearly 30% for the year. North American prices continue to be pressured by robust supplies from unconventional resource plays such as the Marcellus shale, as well as unseasonably warm winter temperatures. Natural gas is a regional commodity, and meaningfully higher prices in Europe and Asia reflect the very different supply/demand dynamics in those regions.

- Many U.S. exploration & production companies accelerated capital expenditures despite weak natural gas prices, with an emphasis on developing oil and natural gas liquids reserves. The U.S. rig count was up 17% year-over-year as of December 22, thanks mainly to increases in unconventional drilling activity, as evidenced by the 22% rise in the horizontal rig count. Rigs issued for new oil wells increased 56% year-over-year as the large price difference between liquids-rich and dry natural gas prices caused many producers to redirect new drilling capital to liquids-rich unconventional shale basins such as the Eagle Ford in Texas and the Bakken in North Dakota.

- However, the Oil Service Sector Index—a group of public companies that assist in the production, processing, and distribution of oil & gas—fell about 10% for the year.

- A number of investment firms have launched new private equity energy funds: AllianceBernstein, Apollo, Barclays, Blackstone, Goldman Sachs, Kohlberg Kravis Roberts, and Och-Ziff are either currently fund raising or expected to raise funds in 2012. The presence of these new funds will likely increase competition for both oil & gas assets and experienced management teams.

Timber

- The NCREIF Timberland Index returned 0.3% for the four quarters ended September 30, largely due to weak demand from the U.S. housing market, although the index generated a solid ten-year average annual compound return (AACR) of 6.8%.

- The trailing 12-month yield on the NCREIF Timberland Index, which fell from 5.5% in 2005 to 1.5% at the end of 2009, rose to 2.7% at the end of third quarter 2011.

- Southeastern U.S. softwood prices declined during 2011 due to weak demand from a soft housing market and moderately higher inventories, while prices in the Pacific Northwest rose due to robust Asian demand. Meanwhile, prices were generally lower in the Northeastern U.S. hardwood market as demand for finished wood products waned.

- Bid-ask spreads remain wide, as most owners are not distressed and buyers are unenthusiastic given the tenuous state of the U.S. housing market. However, transaction volume has ticked up from an anemic 2010, thanks in part to Rayonier's $330 million acquisition of 250,000 acres of Southeastern U.S. timberland. International markets remained more active throughout 2011, with notable sales activity in Australia, New Zealand, and Brazil.

Venture Capital and Private Equity

U.S. Venture Capital

- U.S. venture capital funds returned -0.7% in the third quarter and 20.9% for the one-year period ended September 30, according to the Cambridge Associates LLC U.S. Venture

Capital Index®. We expect the returns for U.S. venture capital managers for calendar year 2011 to be between 17% and 22%, based on estimated returns for fourth quarter 2011 of between 5% and 7%.

- Venture capital fund raising, which has slowed dramatically since the middle of 2008, increased year-over-year for the first time since 2007, led by four billion-dollar funds. A cumulative total of $18.2 billion was raised by 169 funds, up 32% in US$ terms from 2010. Venture firms also invested more than they raised in 2011.

- Disclosed median pre-money valuations across stages and sectors rose to $21.0 million year-to-date as of September 30, up from $16.9 million in December 2010, and above their 2008 previous high of $20.0 million. Disclosed valuations for late-stage information technology deals rose to $49.5 million year-to-date, up from $39 million in 2010 and their 2007 peak of $40 million.

- There were 52 venture-backed initial public offerings (IPOs) that raised $9.9 billion in 2011, a 31% decline in number but a 41% increase in dollars from 2010. Activity was solid through June, then plunged in the third quarter as market volatility soared, only to pick up again in the fourth quarter, led by a $1.0 billion offering by Zynga and a $700 million offering by Groupon. Information technology companies accounted for 63% of the deals and 77% of the money raised. As of early January, 60 venture-backed companies had filed for an IPO with the Securities and Exchange Commission.

- Merger & acquisition (M&A) activity, meanwhile, increased by 23% in terms of total disclosed value, with 429 deals representing $23.0 billion for the year, compared to 436 deals with a disclosed value of $18.8 billion in 2010. These numbers compare favorably to 2009 and 2008, and are relatively consistent with 2005 and 2006. The vast majority of M&A activity involved information technology companies, including Microsoft's $8.5 billion acquisition of Skype. However, a few high-profile life sciences deals also occurred, including Medtronic's $800 million acquisition of surgical device company Ardian, Inc.

U.S. Private Equity

- Activity in the private equity market turned down in the latter half of 2011, as looming macroeconomic issues have yet to be resolved.

- However, the continued capital overhang also creates pressure for private equity managers to put money to work or return it to investors. As of December 31, we estimate half of the capital raised from 2005 to 2010 had been called, leaving a $376 billion overhang—too large to be absorbed by anything other than a replay of the easy credit–powered 2005–08 environment.

- U.S. leveraged buyout (LBO) deal volume in 2011 picked up in number but not value, with 339 announced U.S. LBOs worth $69.0 billion, compared to 277 deals worth $71.0 billion in 2010, a stark contrast to the 2009 low, when 163 deals worth $23.3 billion were announced. The average deal size in 2011 was $203.5 million, below the 2010 average of $256.3 million. Overall, quarterly deal activity from second quarter 2010 through year-end 2011 has been steady and strong, following six straight quarters of anemic volume.

- High-yield and leveraged loan issuance jumped to $946.1 billion in 2011—from $736.6 billion in 2010 and $404.6 billion in 2009—far above the post-1994 average of $578.0 billion.

- Leverage multiples also continued to climb in 2011, rising from 3.7 times EBITDA in 2009—the lowest since 2001—to 4.6 for 2010 and 4.9 in 2011, in line with the 14-year average of 4.5.

- Anecdotally, private equity managers have become more thematic in their approach and focused on specific situations, with some playing cyclical rebounds while others focus on more stable sectors or those underpinned by demographic growth or commodities.

- Exits increased in the first half of 2011, but dropped off in the second half. Announced M&A transactions totaled $545.0 billion for the first half of 2011 and $485.2 billion for the second half. Private equity–backed M&A transactions totaled $89.8 billion for the year, or 8.8% of total volume.

- U.S. IPOs followed a similar pattern, with a strong first half (95 IPOs raised $30.4 billion) followed by a weak second half (51 IPOs raised $11.5 billion). The third quarter was particularly bad, with only 20 IPOs raising a mere $4.0 billion, the smallest amount raised since second quarter 2009. Private equity–backed IPOs did better on a relative basis—in the first half of the year, 25 private equity–backed IPOs raised an aggregate $16.7 billion, accounting for 26% of IPOs by number and 55% of capital raised, while in the second half, 21 private equity–backed IPOs raised $5.6 billion.

- U.S. private equity funds returned -4.3% in the third quarter and 13.8% for the one-year period ended September 30, according to the Cambridge Associates U.S. Private Equity Index®. We expect returns for U.S. private equity managers for calendar year 2011 to be between 24% and 26%, based on estimated returns for fourth quarter 2011 of between 4% and 6%.

- Fund-raising activity for U.S.-based venture capital, private equity, and mezzanine firms remains well below peak levels—the 2011 total of $122.4 billion was roughly in line with 2010 numbers. Many managers are expected to come to market in 2012.

European Venture Capital and Private Equity

- The European lending market was active in the first half of 2011, but came to a virtual standstill in the second half as the sovereign debt crisis worsened. Buyout deal volume and value in the third quarter totaled 187 deals and €14.8 billion, down 36% and 49%, respectively, on a strong second quarter, and representative of the overall low activity level late in the year.

- Investors have continued to aggressively compete for deals, especially in the large-/upper-middle-market segment, driven by a capital overhang that needs to be invested over the next two to three years. Many of the deals we have seen continue to be sponsor-to-sponsor buyouts.

- We do not see any capital overhang in European venture capital; indeed, European venture managers appear to be suffering from a dearth of opportunities. According to Incisive Media's *unquote" Private Equity Barometer Q3 2011*, there were 30 early-stage investments in European venture-backed companies in the third quarter, a 39% decrease from the second quarter, although value increased 3% to €178 million; year-to-date, volume and value are about 20% lower than 2010 figures.

Asian Venture Capital and Private Equity

- Early stage venture in both India and China—especially in the Internet and e-commerce sectors—saw significant valuation increases in 2011, partly due to interest from later-stage and global funds.

- Entry valuations for growth equity investments in China and India have moderated slightly, in line with public market declines, but remain high due to competition for deals. Deals in Indonesia, emerging as a hot destination for private equity investors, have also been completed at full valuations or higher.

- The mid-market buyout market in Australia and Japan continues to be less intermediated and offer reasonable valuations. Deal volume for large-cap transactions has been sporadic, although thanks to the higher level of intermediation in this market segment, entry valuations have occasionally been rich.

Latin American Private Equity

- We view Latin American private equity as fairly valued, especially in the middle and lower-middle-market segments. Valuations for larger deals have increased, supported by strongly performing public markets.

- Large capital inflows into the region, and more private equity firms competing for deals, are also placing upward pressure on valuations. According to the Latin American Venture Capital Association, private equity firms raised more than US$8 billion in 2010, compared with US$3.6 billion in 2009, US$6.4 billion in 2008, and US$5.3 billion in 2007. For 2010, regional funds raised roughly US$5 billion, with the remaining $3 billion raised mostly by country-specific funds in Brazil, Mexico, Peru, and Colombia.

Private Real Estate

United States

- The U.S. real estate market remains bifurcated, with significant investor interest in institutional-quality assets in major metropolitan markets, but stagnant prices for lower-quality assets (i.e., those in secondary or tertiary markets).

- The Cambridge Associates Real Estate Index generated average net internal rates of return for the one-, three-, five-, and ten-year periods ending September 30, 2011, of 14.1%, -7.9%, -4.3%, and 1.9%, respectively.

- On average, U.S. property values remain below physical replacement costs. According to AEW Research, private real estate values bottomed during the first half of 2010, but remain 25% below their peak. While fundamentals are showing modest signs of improvement, with occupancy and rental rates above their troughs, this is tempered by slow job growth. Vacancies in the office, industrial, and retail sectors are all near record highs.

- Transaction volume—$82 billion year-to-date through August and expected to approach $100 billion by year-end—has steadily increased since bottoming in second quarter 2009, with deals focused on very high-quality, income-generating assets in major cities. However, volume declined in the second half of 2011, thanks in part to concerns over the European debt crisis. Overall, transaction volume remains well below the 2007 peak, according to Real Capital Analytics.

- Commercial mortgage–backed securities issuance was expected to reach just $30 billion during 2011, up from $11 billion in

2010, but a fraction of peak levels. Moreover, yield spreads for lower-quality AAA tranches widened sharply over August and September, which will only exacerbate the bifurcation in the market.

- Recent transaction activity suggests the "extend and pretend" phase may be coming to an end, as more lenders have the financial strength to take a tougher stance with borrowers and withstand losses on their balance sheets.

Europe ex U.K.

- Despite rental growth in some core locations, real estate fundamentals were mostly flat across Europe for the third quarter. Net absorption remained positive at 2.9 million square meters, but was down 24% from the prior quarter, while the vacancy rate stayed at 10.2%. Western European vacancy rates held steady at 9.7%, while those in the Central and Eastern Europe market ticked down 20 bps to 14.9%.

- However, a lack of new supply in some core markets is leading to rental growth, as there are few finished developments coming online during 2012–14. Completion of new office space during the first three quarters of 2011 totaled 2.3 million square meters, 45% below the ten-year average.

- Transaction activity remains concentrated in Northern and Central Europe. Year-to-date through the third quarter, transaction volumes in Germany (79%), France (26%), Scandinavia (60%), and Central and Eastern Europe including Russia (150%) are notably higher than in other European ex U.K. markets, according to Jones Lang LaSalle.

- Like the United States, European property markets remain bifurcated, resulting in a wide spread in valuations depending on asset quality and location. European prime office yields remained at 5.25% in the third quarter, unchanged from the previous two quarters.

- Financing markets remain effectively closed, with banks that are willing to lend doing so only on strict terms. Loans for speculative development, as well as anything non-prime or in Southern European markets, are virtually nonexistent.

United Kingdom

- U.K. property fundamentals are improving, due in large part to a lack of supply, with rents stabilizing and capital inflows to core property. Demand for stabilized assets remains strong, as both foreign and local investors remain attracted to assets with decent yields.

- Transaction volume in London dropped to £2.0 billion in the third quarter, 25% below the previous quarter's level and 19% below the long-term average, according to Knight Frank. Average transaction size was also lower.

- The West End vacancy rate stood at 5.9% in the third quarter, compared to 7.1% at the beginning of 2011, and is 25% below the long-term average, according to Knight Frank. Prime headline rents rose incrementally in the third quarter, while prime yields remained at 4%.

- Vacancy in the City, meanwhile, stood at 7.7%, down from 8.9% at the beginning of the year, while prime rents remain unchanged from last year. Year-to-date leasing activity is 1.9 million square feet less than the same period in 2010. Yields stayed at 5.25% for the fourth consecutive quarter.

- Outside of prime London locations, concerns about prolonged weak fundamentals prevail, and investor demand remains weak.

Asia

- Soft demand growth, declining yields, and weak returns have characterized Asia Pacific real estate markets during the last two quarters, with yields in Hong Kong and Singapore reaching record lows.

- Total Asia Pacific real estate transaction volume for the four quarters ended in September was about $50 billion, with third quarter volume rising 36% quarter-over-quarter.

- In mainland China, residential property prices have dropped sharply thanks in part to government restrictions on bank lending, although construction levels remain high.

- Residential prices in Hong Kong and Singapore have exceeded pre-crisis levels, prompting governments in both countries to introduce anti-speculation measures. Singapore recently introduced a higher special stamp duty tax (10%) for foreigners and multiple home owners in an attempt to reduce inflow of Chinese buyers and speculation. The Hong Kong government introduced a similar tax in late 2010.

Global Real Estate Securities[3]

- Following two consecutive years of blockbuster returns, global developed property securities regressed in 2011, returning -5.8%. Still, developed property stocks have returned nearly 145% since March 2009, though the global index remains 31% below its February 2007 peak.

- North America was the best-performing region by a wide margin, with the FTSE® EPRA/NAREIT North America Index returning 8.2%. U.S. REITs returned 7.8%, while the smaller Canadian market returned 12.3%. In contrast to 2009 and 2010, when returns were driven predominantly by capitalization rate compression, 2011 performance was attributable to current yield and improved operating results.

- Developed Asian property securities, on the other hand, returned -19.6%, thanks in part to government policy measures aimed at reining in residential property prices, particularly in the development-heavy Hong Kong and Singapore property securities markets, which returned -25.3% and -27.7%, respectively. Developers, which have greater residential market exposure, lagged owner/operator businesses in both countries, by 6.8% and 23.1%, respectively.

- Japanese property stocks, meanwhile, ground lower for much of 2011, with declines obviously exacerbated by the March earthquake and tsunami. The Japanese subindex fell 17.5% during the first two days of post-earthquake trading, and closed the year down 22.1%. J-REITs did slightly better, due partly to the Bank of Japan's direct purchases of J-REITs, while Australia (-2.0%) was the region's best performer.

- The FTSE® EPRA/NAREIT Developed Europe Real Estate Index returned -12.3% as the sovereign debt crisis continued to mushroom. Country returns ranged from Spain's -59.7% to Switzerland's 5.2%, with the heavyweight U.K. and French markets returning -8.6% and -11.4%, respectively.

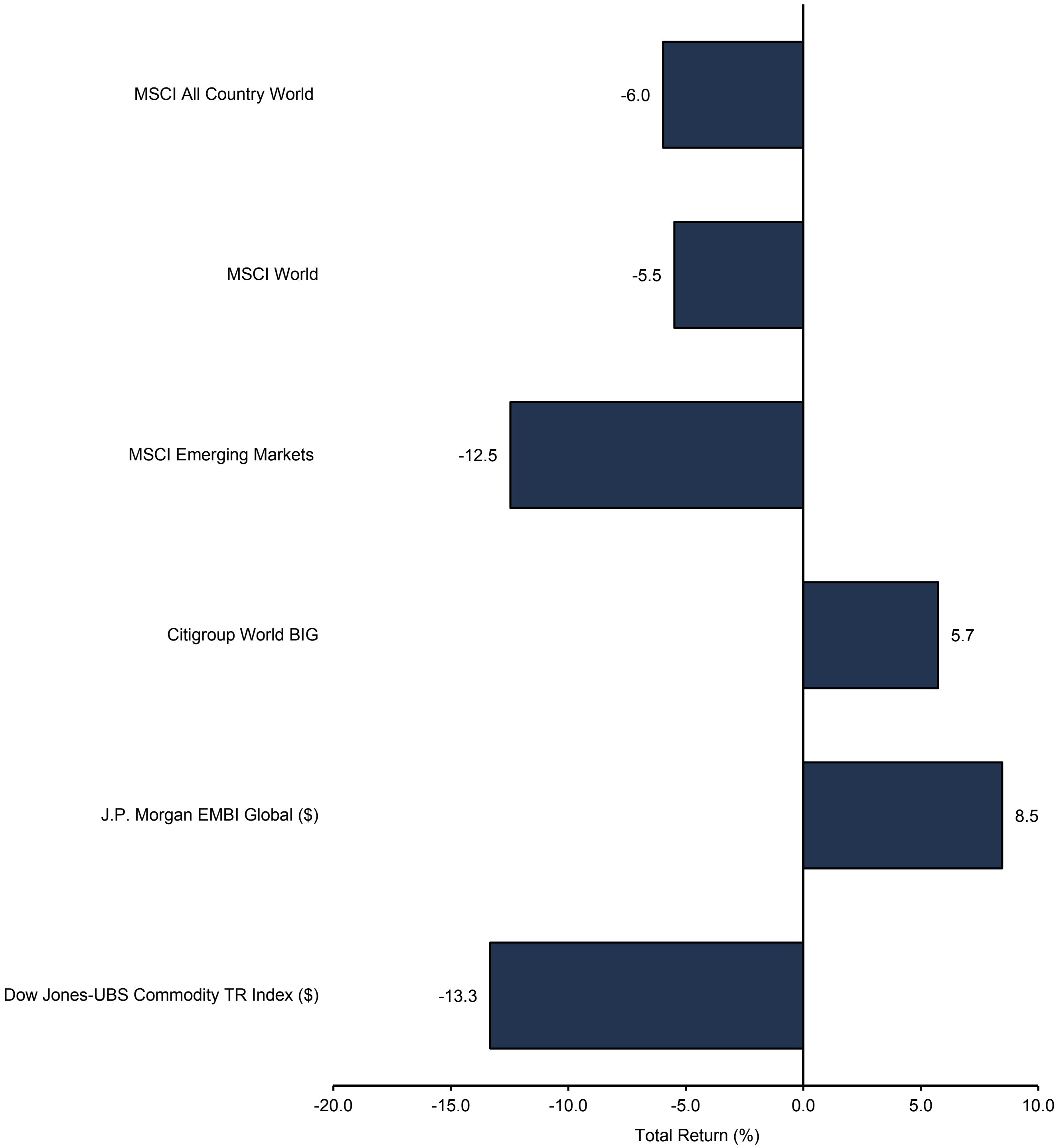
[3] All returns in this section are in US$ terms.

- Over the past three- and five-year periods, U.S. property securities have been by far the best regional performers, posting AACRs of 21.1% and -2.2%, respectively. Asia has returned 10.6% and -5.9%, and Europe, 10.4% and -13.1%, due in large part to the U.K. five-year AACR of -21.3%. ■

Exhibit 1

Comparative Performance of Various Capital Markets

2011 • Local Currency

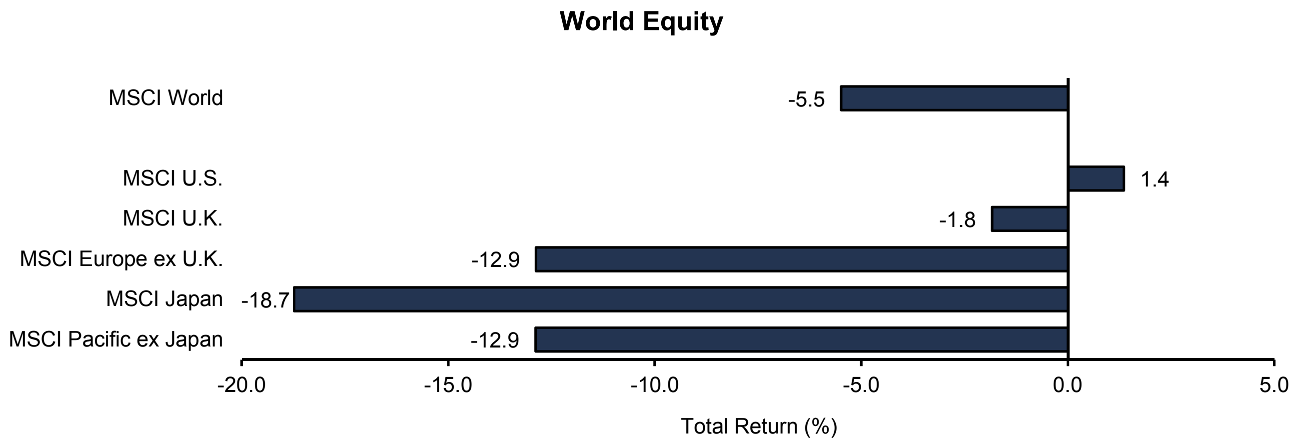


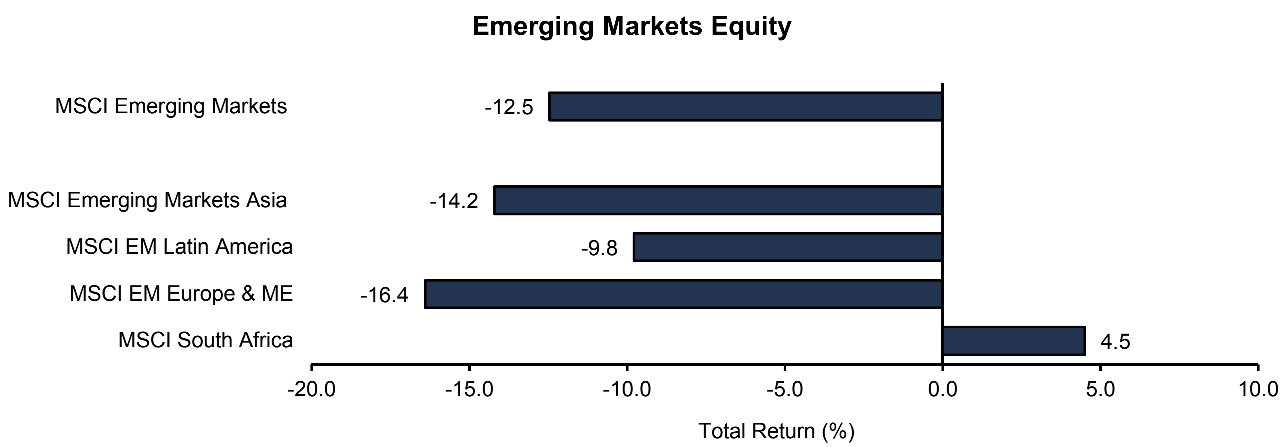
Sources: Bloomberg L.P., Citigroup Global Markets, Dow Jones & Company, Inc., J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI Emerging Markets and All Country indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.
2101q (mod)

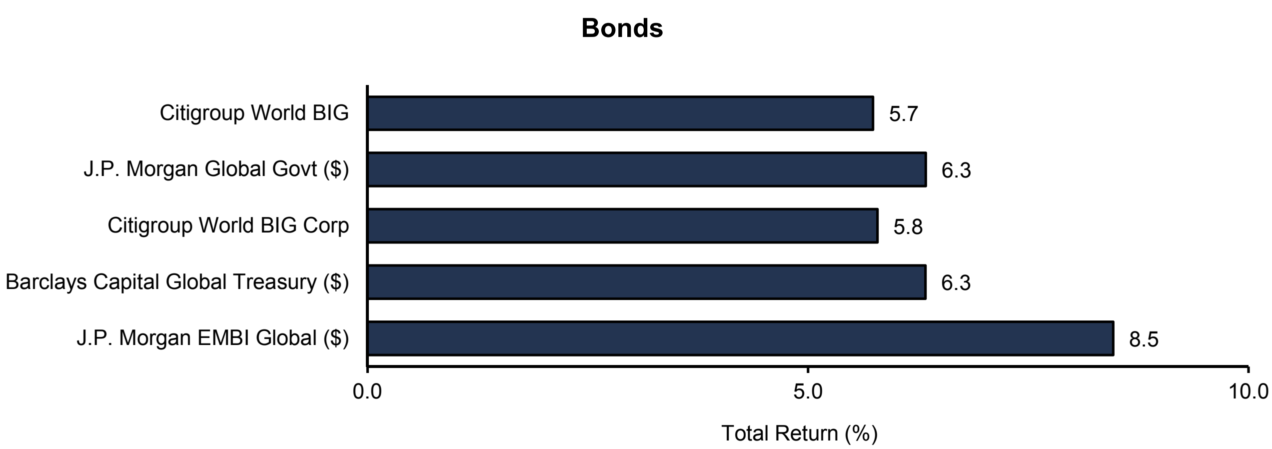
Exhibit 2

Regional Performance of Various Capital Markets

2011 • Local Currency

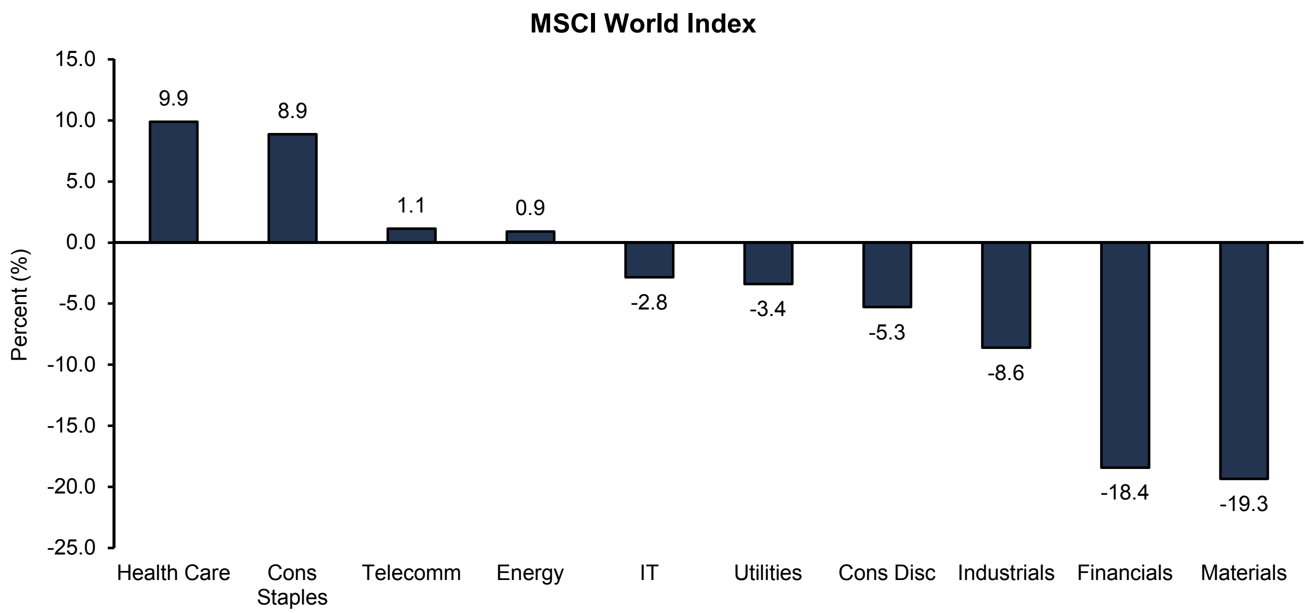


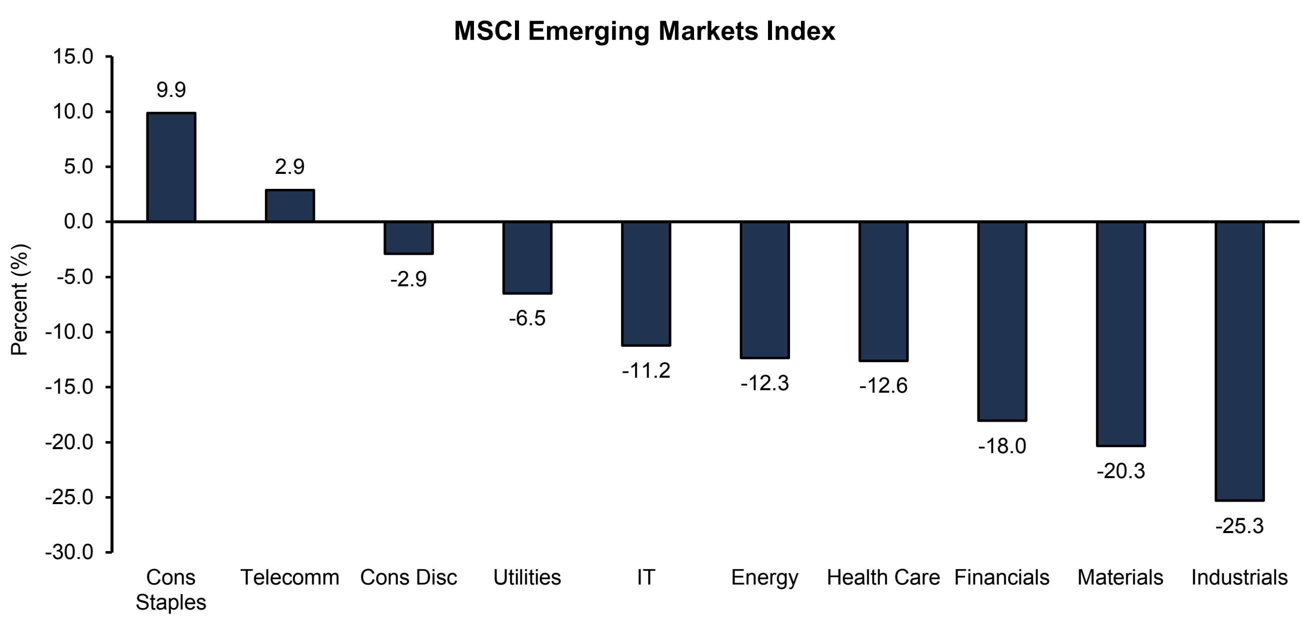




Sources: Barclays Capital, Bloomberg L.P., Citigroup Global Markets, J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI Emerging Markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.
2100q (mod)

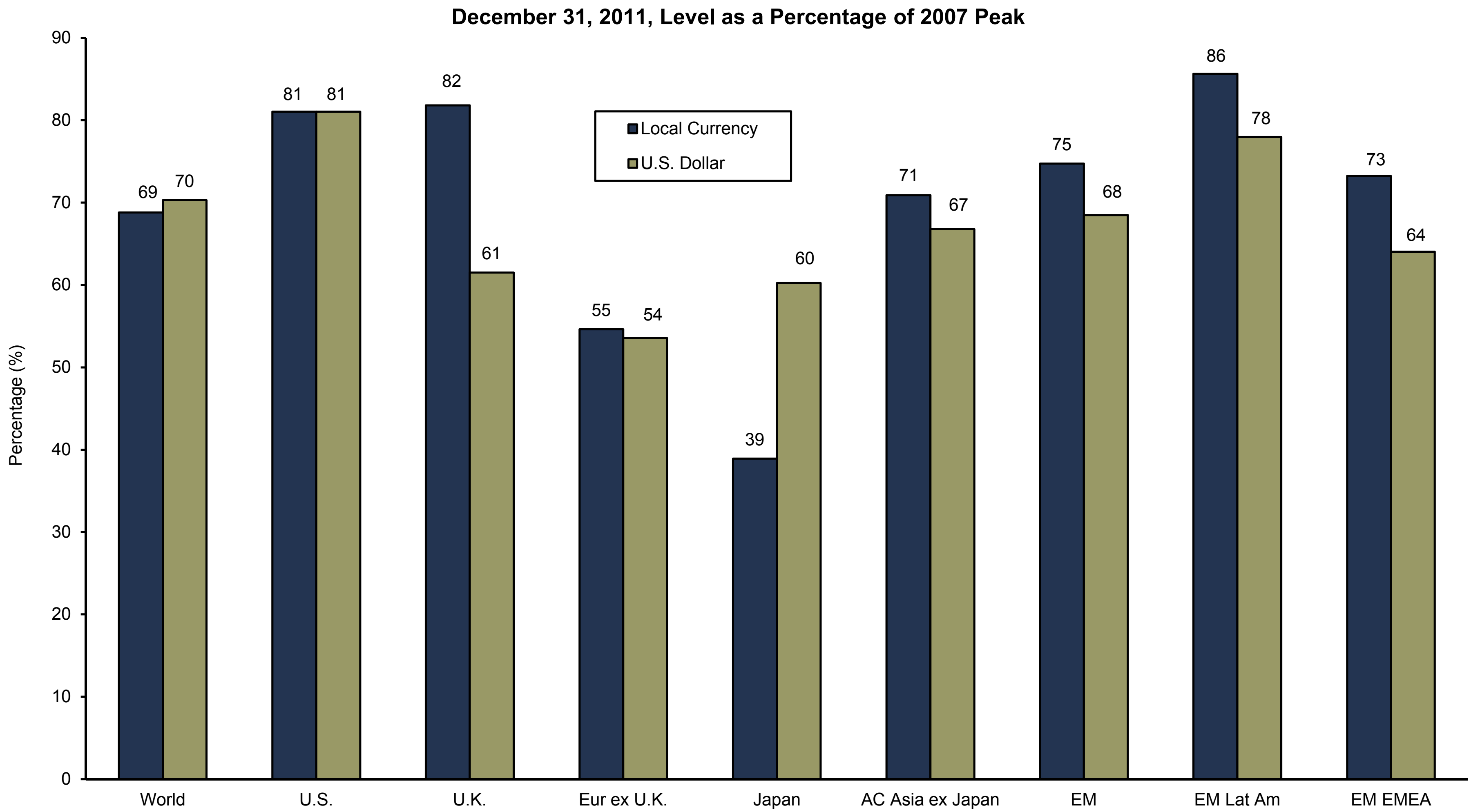
Exhibit 3
Global Equity Sector Performance
2011 • Local Currency





Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI developed markets indices are net of dividend taxes. Total returns for MSCI emerging markets indices are gross of dividend taxes. Charts are sorted by 2011 annual sector performance.

Exhibit 4
Global Market Levels as a Percentage of 2007 Peak Level

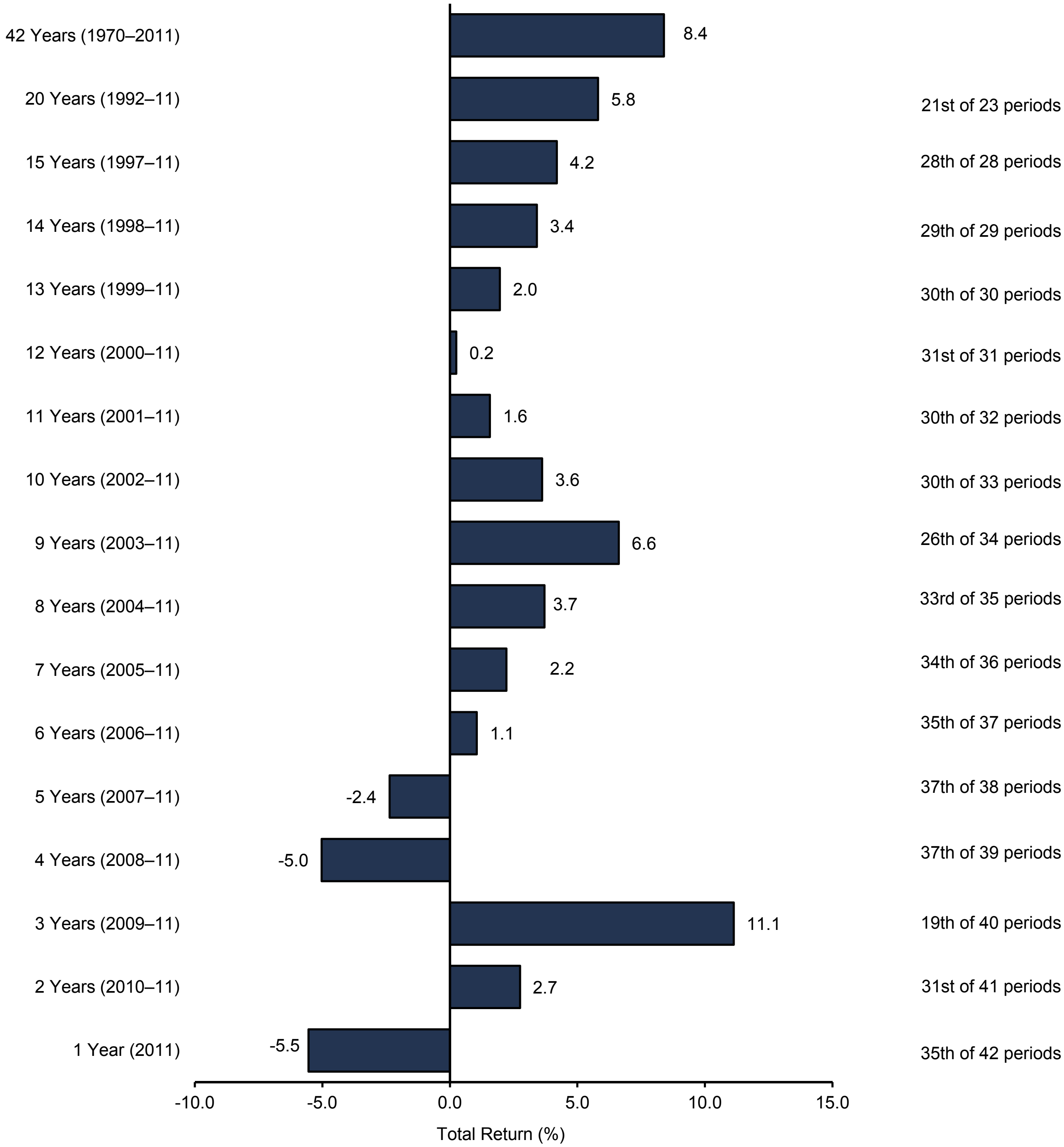


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Graph represents current market levels as a percentage of their 2007 peak. MSCI Emerging Markets Latin America data represent 2007 peak on October 29, 2007. The absolute peak for MSCI Emerging Markets Latin America occurred in May 2008.

Exhibit 5

MSCI World Average Annual Compound Returns for Various Time Periods

Periods Ended December 31, 2011

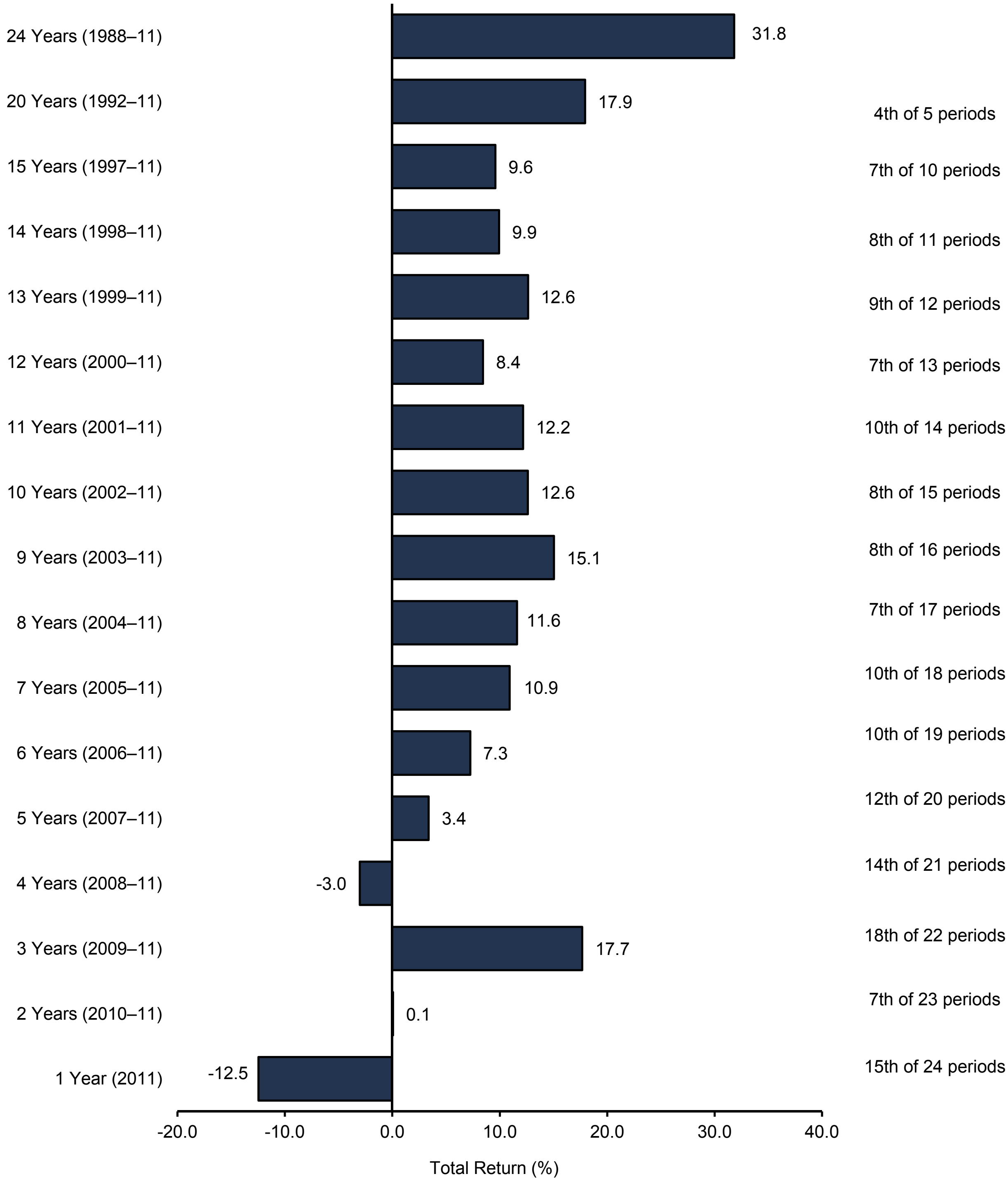


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: A ranking of first indicates the best performance among all periods. Total returns for the MSCI World Index are net of dividend taxes.

Exhibit 6

MSCI Emerging Markets Average Annual Compound Returns for Various Time Periods

Periods Ended December 31, 2011

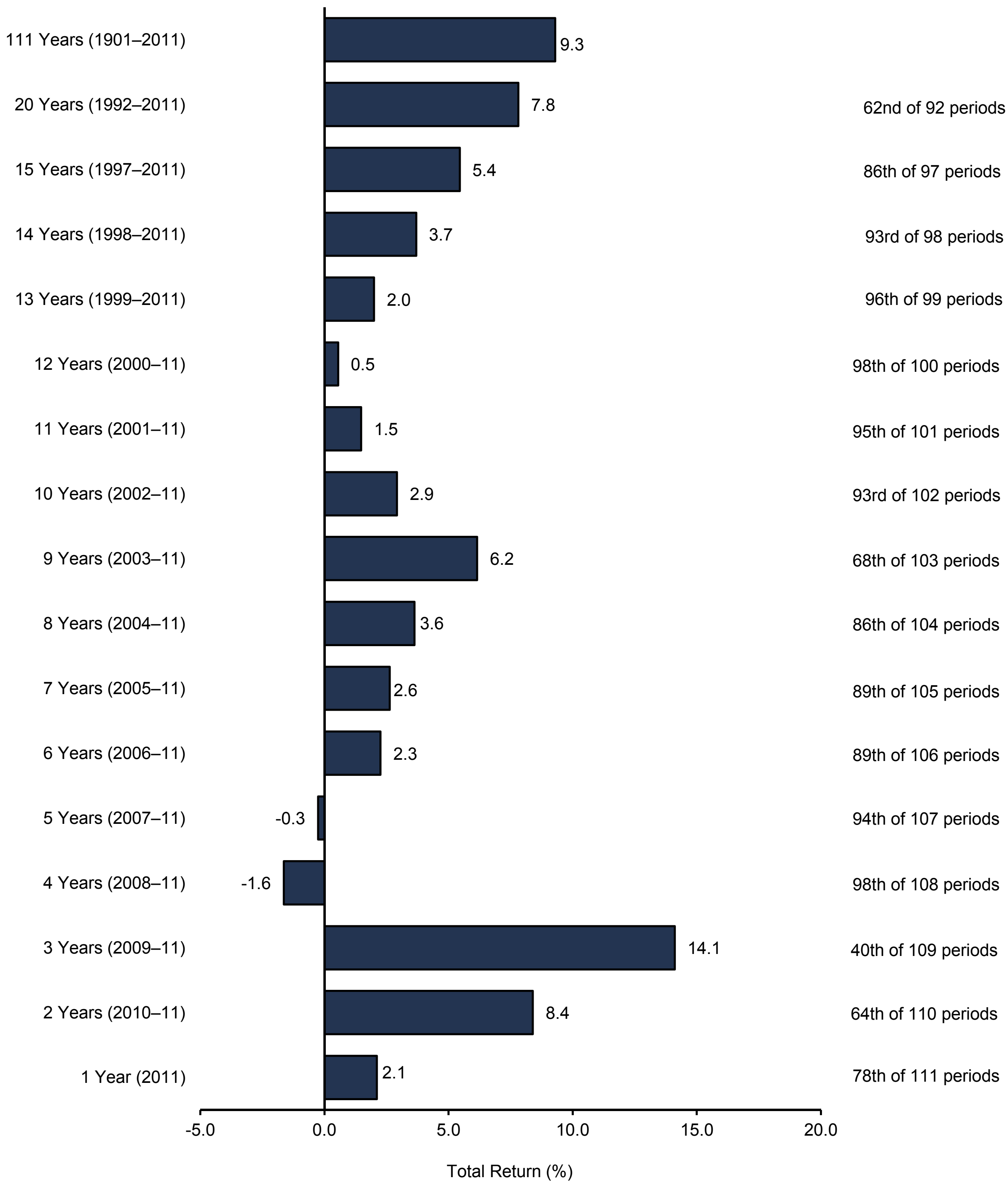


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: A ranking of first indicates the best performance among all periods. Total returns for the MSCI Emerging Markets Index are gross of dividend taxes.

Exhibit 7

S&P 500 Average Annual Compound Returns for Various Time Periods

Periods Ended December 31, 2011 • U.S. Dollar

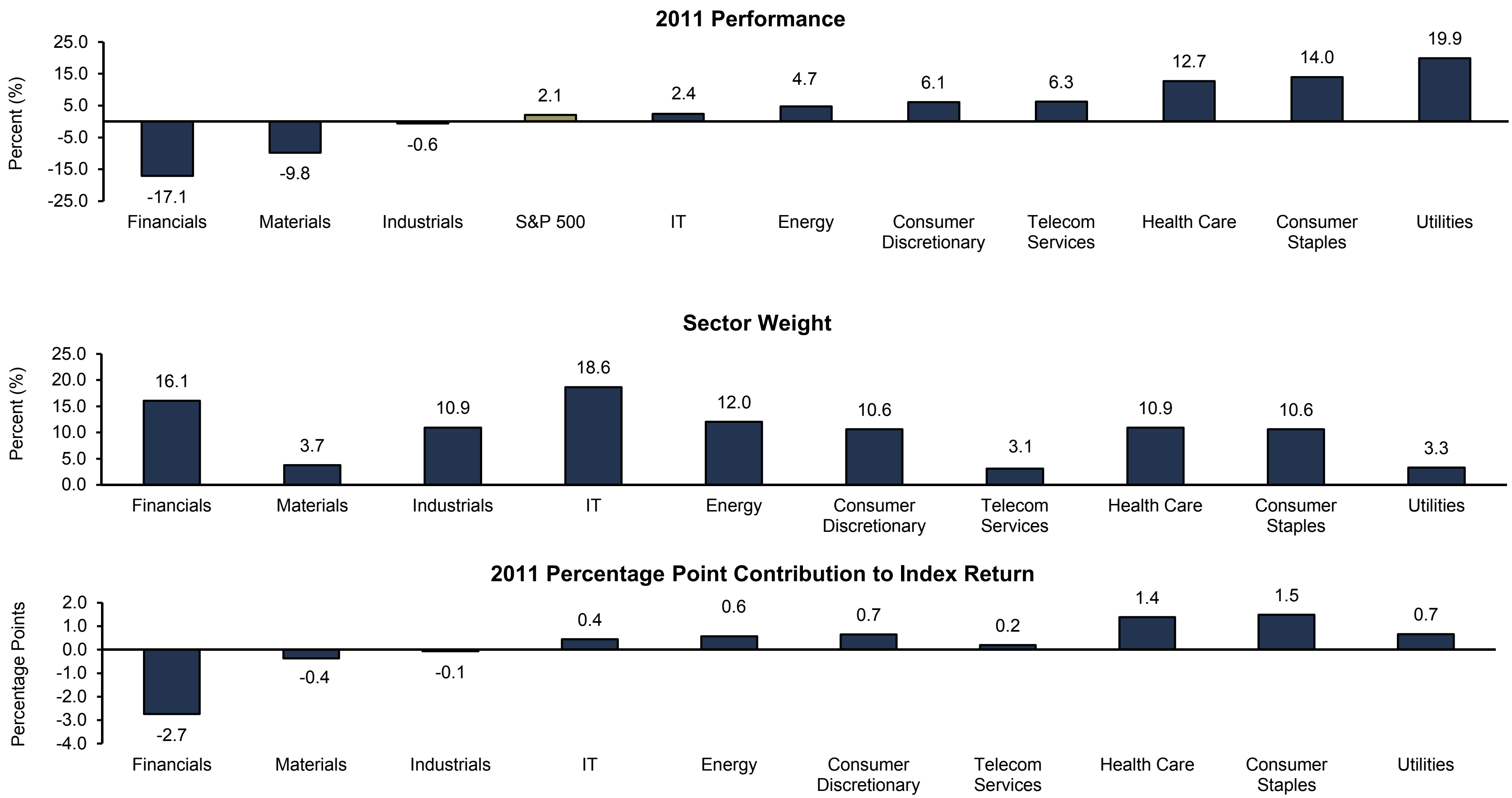


Sources: Global Financial Data, Inc., Standard & Poor's, and Thomson Datastream.
Note: A ranking of first indicates the best performance among all periods.

Exhibit 8

S&P 500 Economic Sector Weights and Contribution

As of December 31, 2011 • U.S. Dollar

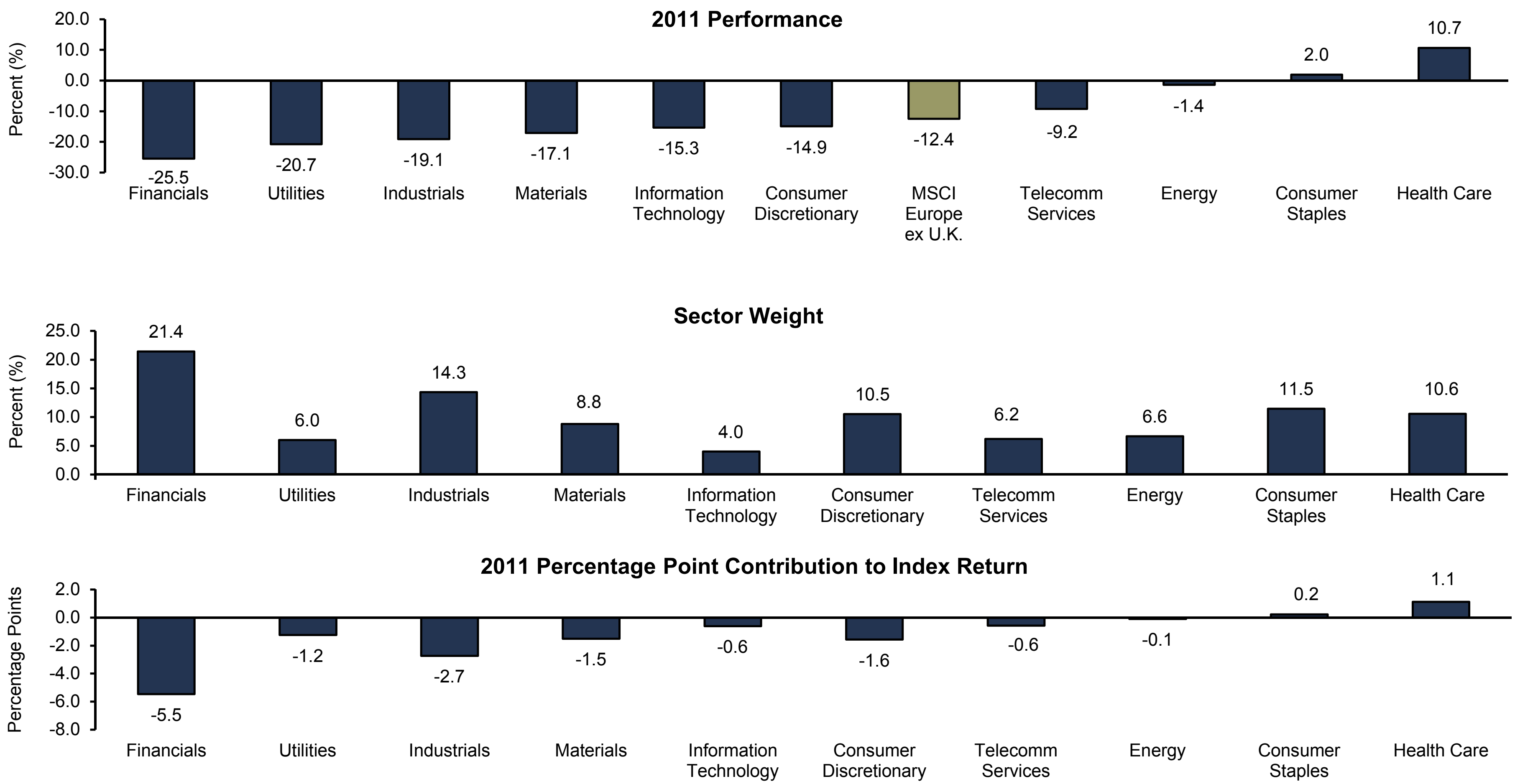


Sources: Standard & Poor's and Thomson Datastream.
Notes: Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative total return from December 31, 2010, to December 31, 2011. Percentages may not total due to rounding.

Exhibit 9

MSCI Europe ex U.K. Economic Sector Weights and Contribution

As of December 31, 2011 • Euro

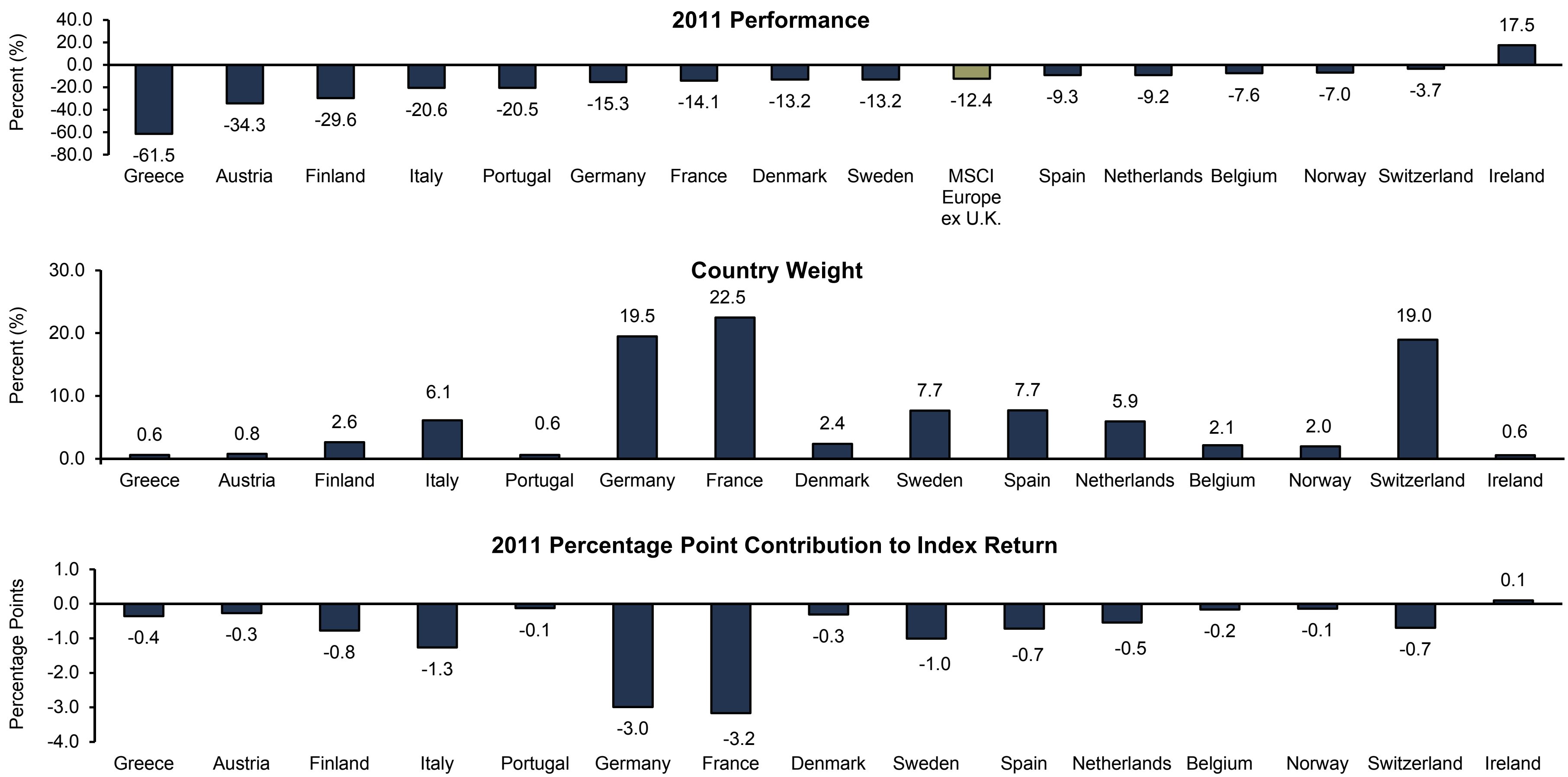


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative total return from December 31, 2010, to December 31, 2011. Percentages may not total due to rounding. Returns are net of dividend taxes.

Exhibit 10

MSCI Europe ex U.K. Country Weights and Contribution

As of December 31, 2011 • Euro

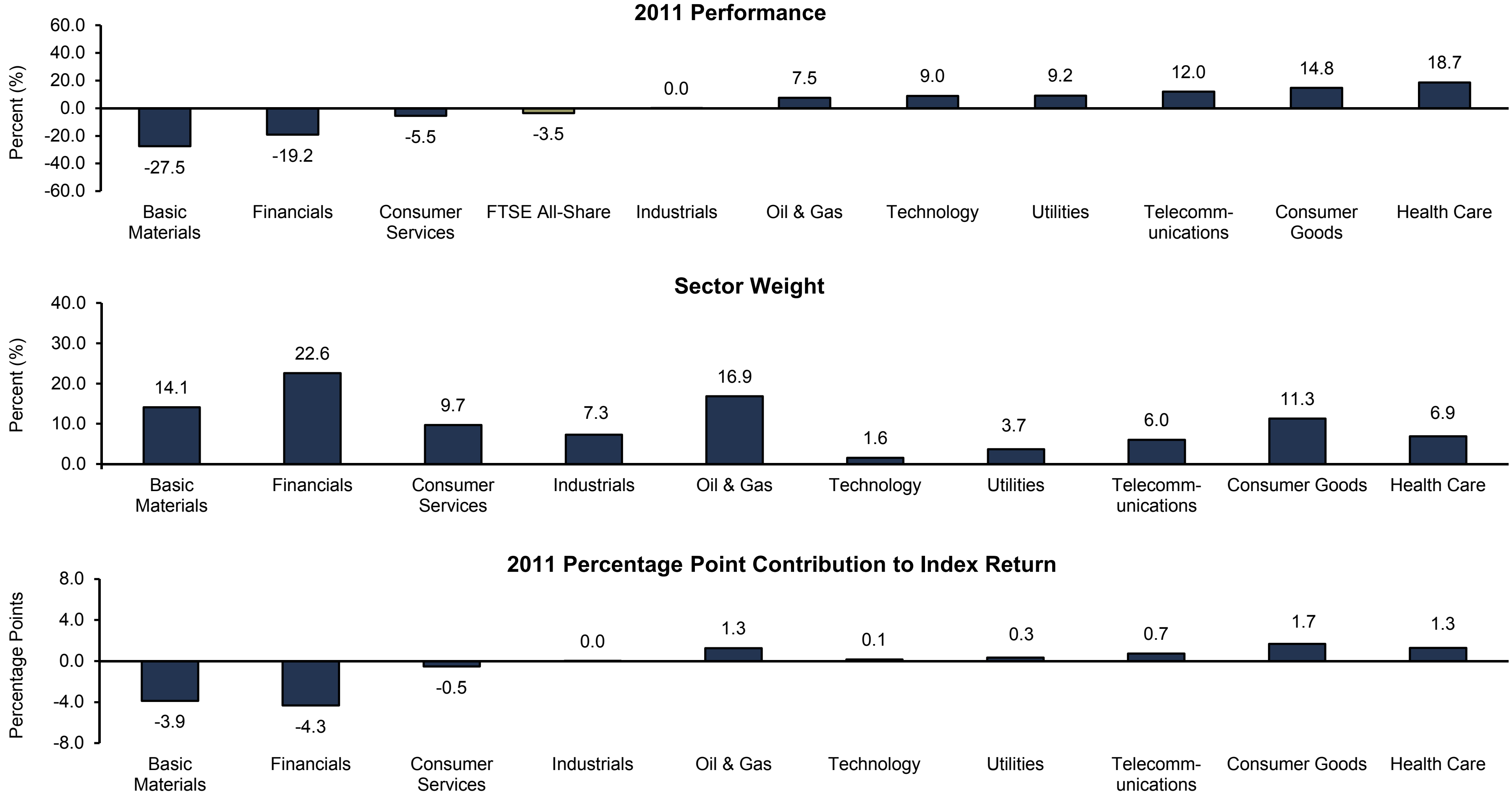


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative total return from December 31, 2010, to December 31, 2011. Percentages may not total due to rounding. Returns are net of dividend taxes.

Exhibit 11

FTSE® All-Share Economic Sector Weights and Contribution to Return

As of December 31, 2011 • Pound Sterling

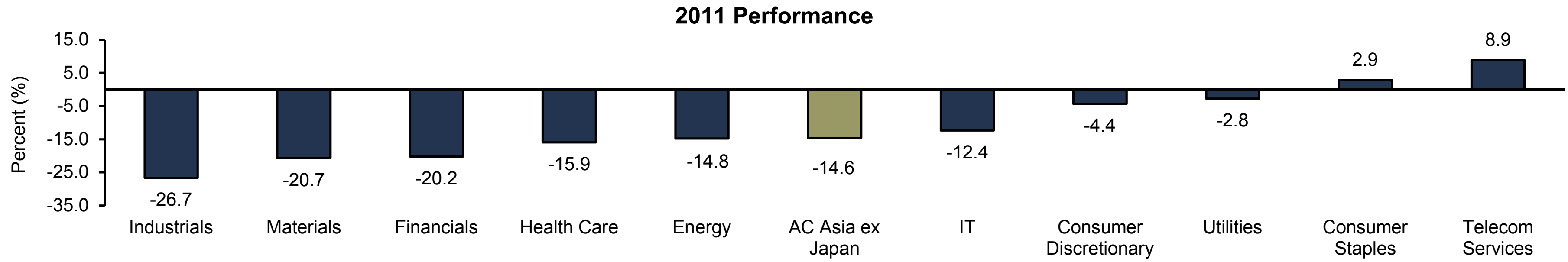


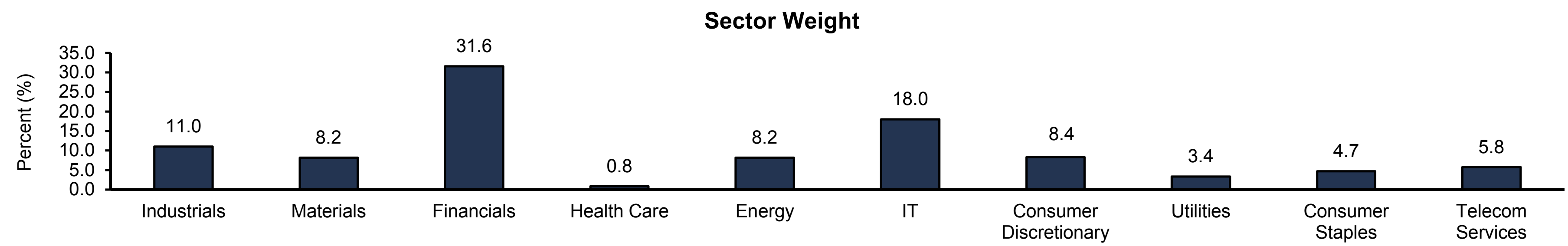
Sources: FTSE International Limited and Thomson Datastream.
Notes: Weights may not total to 100% due to rounding. ICB sectors shown for FTSE® All-Share Index. Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative local currency return from December 31, 2010, to December 31, 2011.

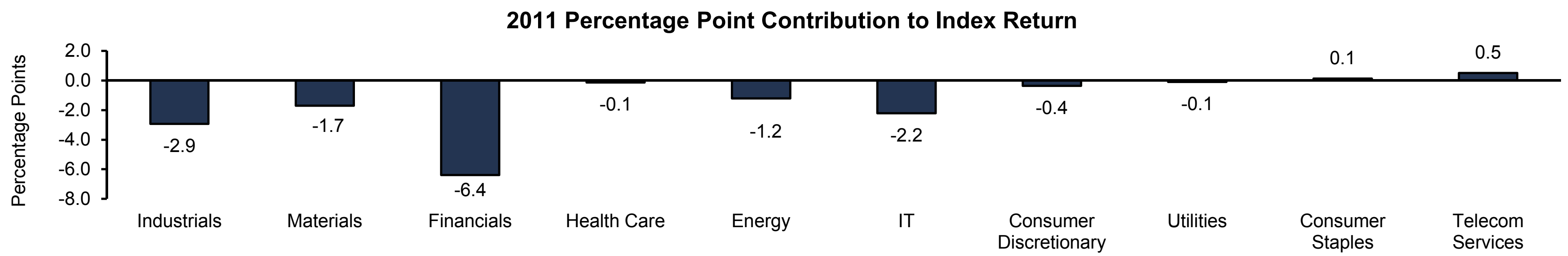
Exhibit 12

MSCI All Country Asia ex Japan Economic Sector Weights and Contribution

As of December 31, 2011 • U.S. Dollar





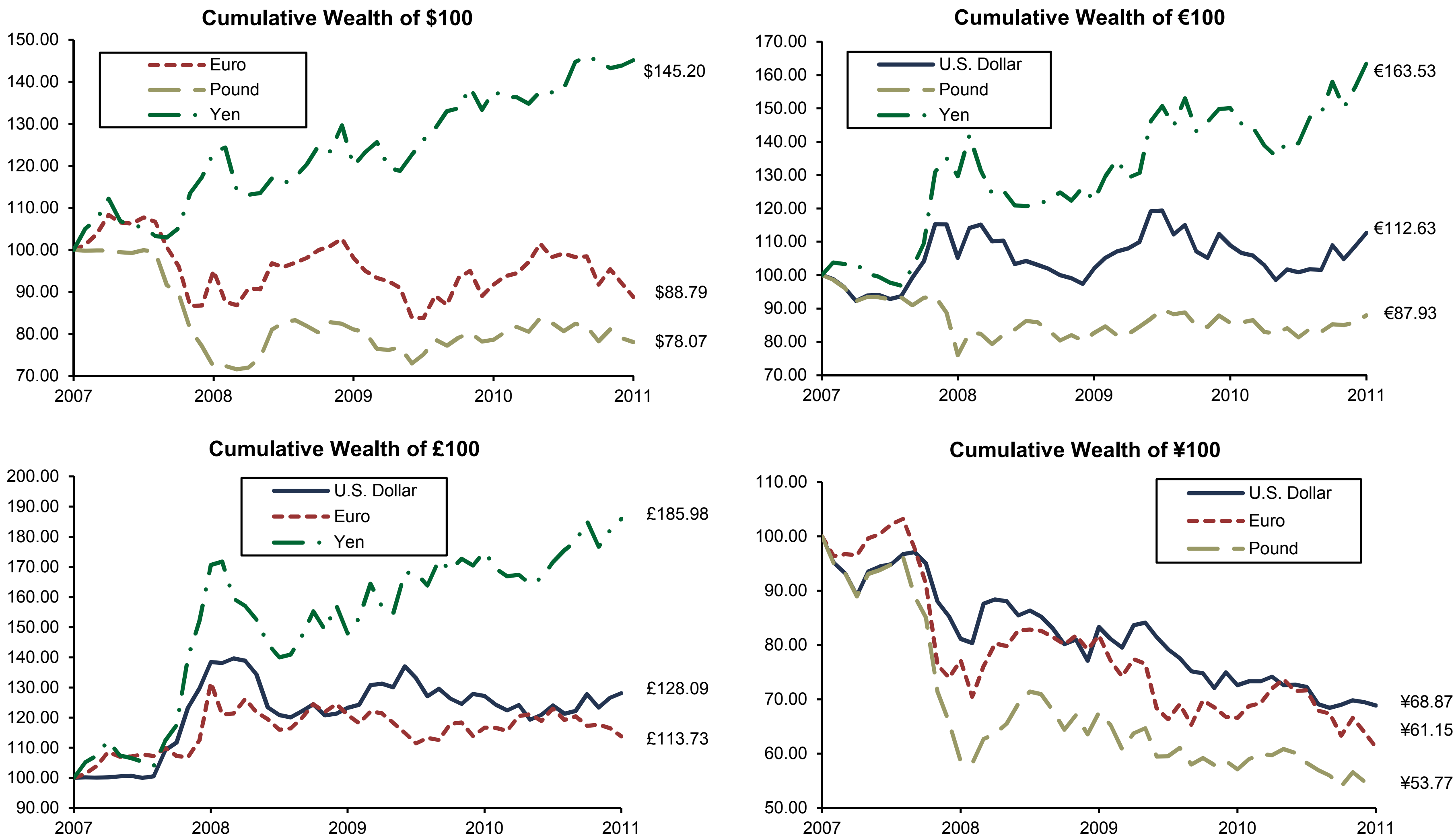


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative local currency return from December 31, 2010, to December 31, 2011. Percentages may not total due to rounding. Returns are gross of dividend taxes.

Exhibit 13

Cumulative Wealth for Various Currencies

December 31, 2007 – December 31, 2011

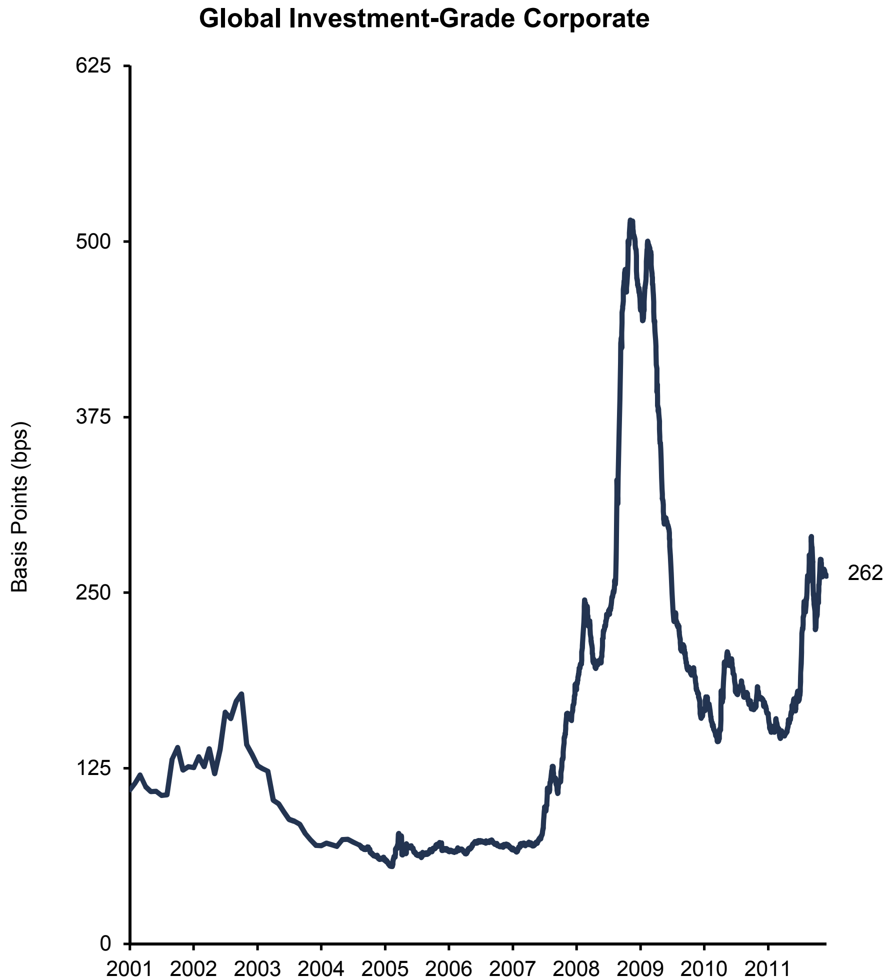


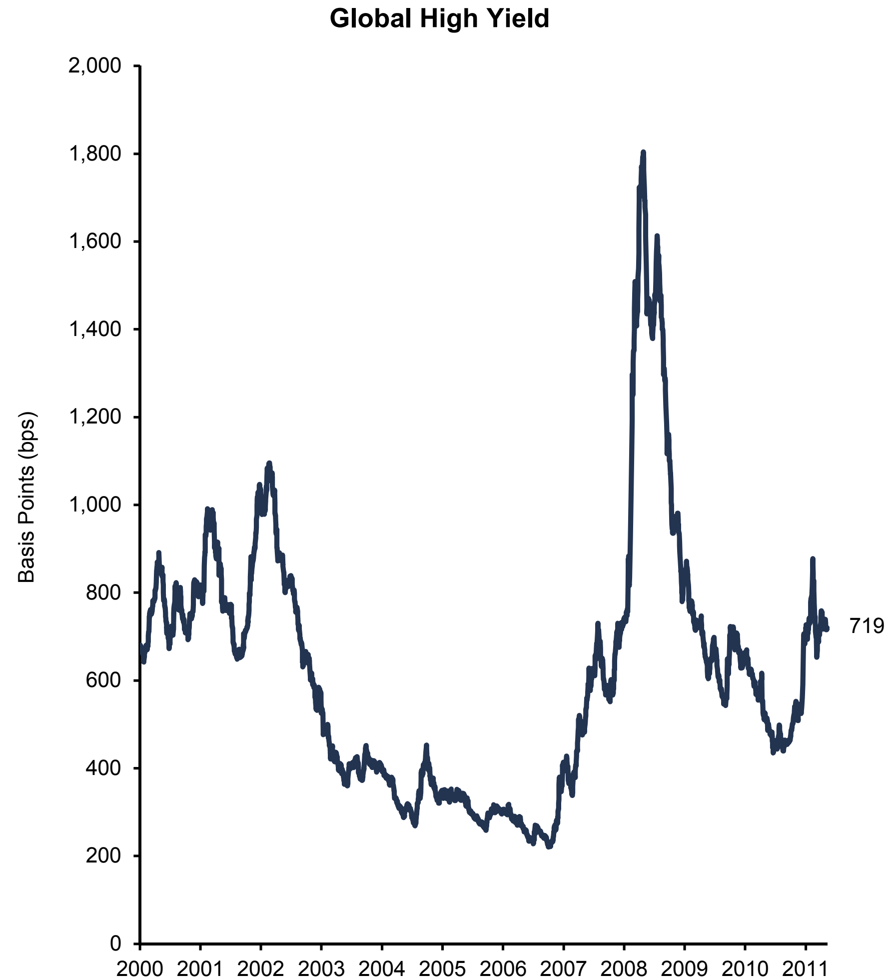
Source: Thomson Datastream.

Exhibit 14

Option-Adjusted Spreads on Global Corporates and High Yield

August 23, 2000 – December 31, 2011





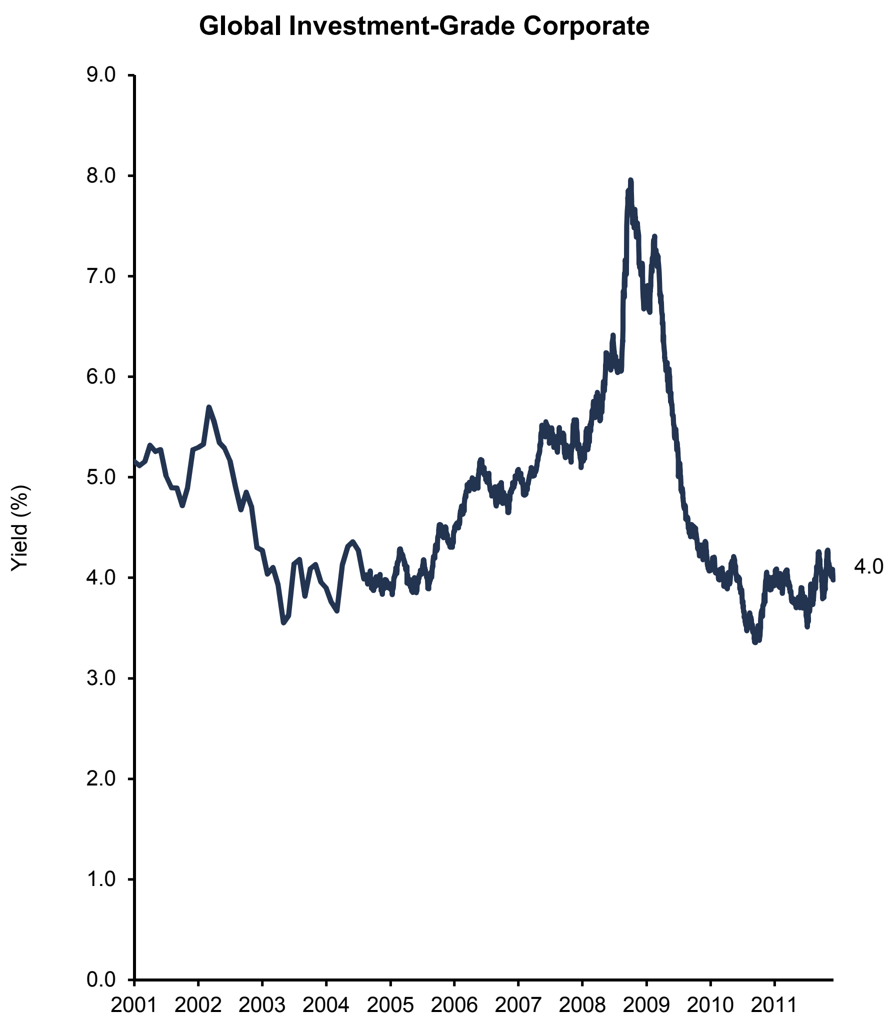
Source: Barclays Capital.

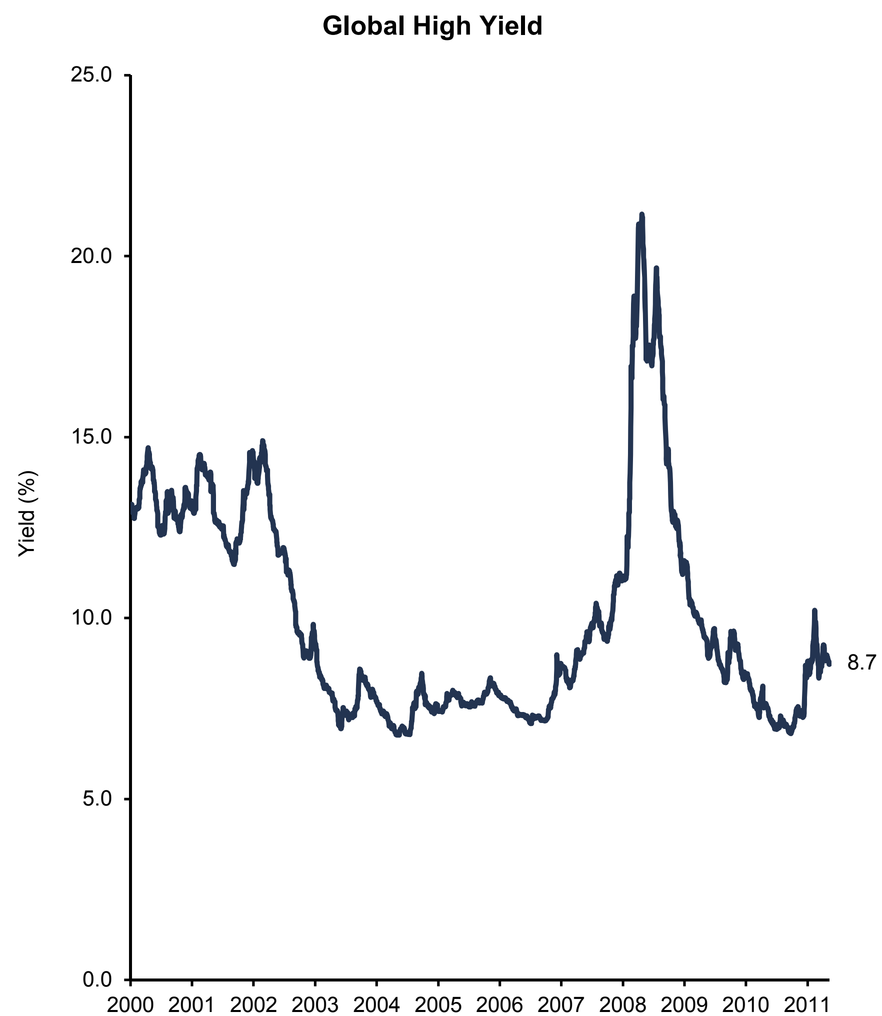
Notes: Monthly data for investment-grade corporates start January 2001. Daily data for investment-grade corporates begin September 14, 2001.

Exhibit 15

Yields on Global Corporates and High Yield

August 23, 2000 – December 31, 2011





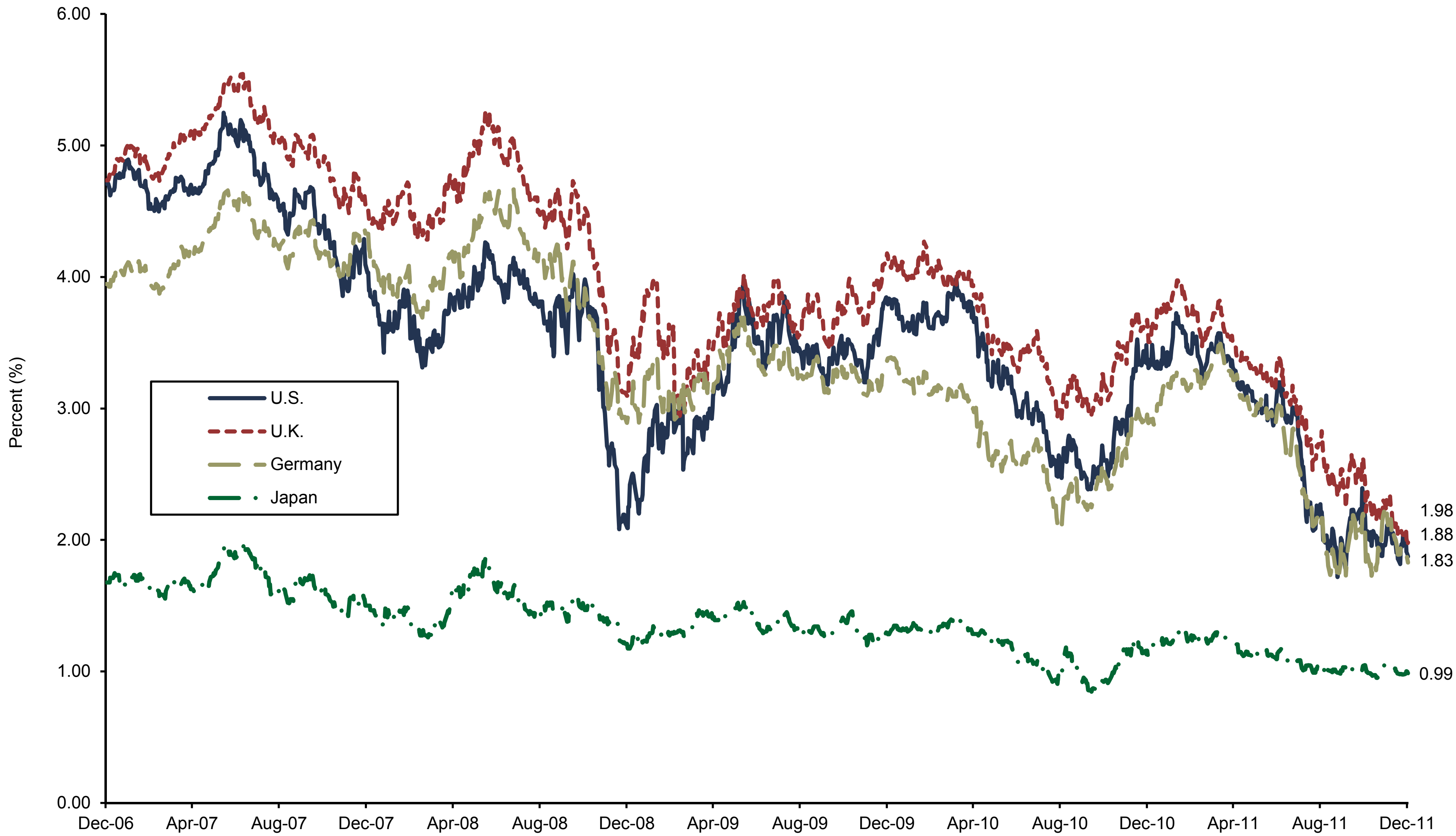
Source: Barclays Capital.

Notes: Monthly data for investment-grade corporates start January 2001. Daily data for investment-grade corporates begin September 14, 2001.

Exhibit 16

Ten-Year Government Bond Yields

December 31, 2006 – December 31, 2011



Source: Thomson Datastream.
910m