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CAMBRIDGE ASSOCIATES LLC

# U.S. MARKET COMMENTARY

## Fiscal Year 2011 in Review

## July 2011

July 2011 U.S. Market Commentary

# Fiscal Year 2011 in Review

Published Research & Manager Research Teams

**Summary highlights for various asset classes for the fiscal year ended June 30, 2011.**

## Developed Market Equities

### Global

- Fiscal year 2011 was the best for developed markets equities since 1987, with the MSCI World Index returning 30.5%[1] and outperforming emerging markets for the first time since fiscal year 2001, although emerging markets did return 28.2%. However, the impressive returns are a bit misleading, as gains were concentrated in the second half of 2010, after Ben Bernanke's Jackson Hole speech where he laid the groundwork for QE2. Calendar year-to-date returns for the MSCI World Index and the MSCI Emerging Markets Index are just 5.3% and 1.0%, respectively.

- The rally was broad based, with all economic sectors firmly in positive terrain. Energy (46.3%) and materials (42.7%) did the best thanks to surging commodity prices, while financials (20.7%) and utilities (17.0%) lagged.

- All developed regions posted similar gains save Japan (13.0%), which of course suffered from the March earthquake/tsunami. Outside Japan, returns ranged from 36.9% (Europe ex U.K.) to 30.7% (United States). Individual country returns were spectacular as well, with every country in the black (and 13 posting returns greater than 30%).

- Global small caps beat large caps by nearly 10 percentage points—their third straight fiscal year of outperformance. Among style segments, meanwhile, the MSCI World Growth Index outperformed its value counterpart by 397 basis points (bps).

- Returns were also boosted by the weakening U.S. dollar, which fell against every currency we track save the Argentine *peso*, with a considerable 15.5% drop against the euro. The MSCI All Country World Index returned 21.7% in local currency terms, 9 percentage points lower than in US$ terms.

- We continue to view global equities in aggregate as fairly valued, though valuations are above long-term averages, particularly in the United States, which we regard as overvalued. Among non-U.S. equities, we view Pacific ex Japan and European equities as fairly valued, while Japanese equities are undervalued. Emerging markets, meanwhile, remain fairly valued, but slightly pricey relative to developed markets. We continue to believe investors should stay defensive and tilt toward high-quality assets, although a drastic bet against equities is not warranted, as global monetary policy is set to remain loose and valuations on competing assets are similarly unappealing.

### United States

- U.S. equities posted blockbuster results for the fiscal year, with gains initially sparked by Ben Bernanke's hint in late August that QE2 was forthcoming. Indeed, September 2010 was the strongest September in 71 years. However, following a return of 27.7% from September through February, the index was

[1] All returns in this report are total returns in US$ terms for the 12 months ended June 30 unless otherwise noted.

essentially flat through June. The S&P 500 remains 15.6% off its October 2007 peak.

- The S&P 500 Index trounced the MSCI World ex U.S. Index by 1,688 bps in local currency terms, but just 36 bps in US$ terms thanks to the weak buck. Meanwhile, U.S. equities beat emerging markets equities in local currency terms for the first time in ten years—by an eye-popping 1,356 bps—and by 252 bps in US$ terms.

- All ten S&P 500 economic sectors finished the year in the black, with energy (52.8%) and materials (45.3%) leading the way, while laggard financials (12.8%) trailed the next weakest sector (utilities) by 1,110 bps.

- Growth outperformed significantly across the board, particularly as one moves down the capitalization structure. The Russell 1000® Growth Index bested its value counterpart by 607 bps, while the Russell 2000® Growth Index outpaced small cap value stocks by 1,214 bps.

- Mid caps were the top performer for the second straight year, with the Russell Midcap® Index returning 38.5%. Otherwise, equity performance was stronger moving down the capitalization structure. For example, the Russell 2000®, 1000®, 200®, and 50® returned 37.4%, 31.9%, 29.2%, and 25.7%, respectively.

- Normalized P/E multiples remain well above, and dividend yields well below, long-term averages.[2] Admittedly, many U.S. firms benefit from strong overseas positions, and low bond yields may make equities appear more attractive. Nevertheless, high profit margins, anemic U.S. growth (an annualized 1.6% in the second quarter following 0.5% growth in first quarter), and debt and inflation concerns overseas pose substantial headwinds to earnings. We continue to view U.S. equities as overvalued, as valuations are high and continued earnings strength remains uncertain at best.

## Europe

- The MSCI Europe ex U.K. Index returned 36.9% (in US$ terms) for the fiscal year, a dramatic improvement from its 4.4% return the previous year.

- Currency appreciation drove most of the performance for US$ investors, as QE2 and other factors caused the U.S. dollar to plummet against major European currencies despite the re-intensification of the Greek debt crisis. The euro appreciated 18.4% against the U.S. dollar, while the Swiss franc gained 28.1%. QE2 also helped spur a resurgence in risk appetite during the second half of 2010; European equities captured most of their gain (23.6% in US$ terms) during this period.

- While all markets were in the black, those that fared best typically had improving economic data and were insulated from the crisis. Norway (51.8%), for example, benefitted from currency appreciation but also oil exposure and an insulated banking sector, while Greece (2.6%) lagged. Core markets such as Germany (45.9%) and France (42.1%) outperformed, as earnings soared thanks to decent domestic growth coupled with strong exports to rapidly growing emerging markets.

[2] The Shiller P/E ratio based on ten-year average real GAAP earnings of $59 per share for the S&P 500 ended June at 22.5, or 1.2 standard deviations above its long-term mean of 15.8. Shiller and trend-line P/E ratios for the MSCI U.S. Index traded at 19.7 and 19.9, respectively, based on normalized earnings per share of roughly $64. The return on equity–adjusted P/E ratio on the MSCI U.S. Index, on the other hand, is a more reasonable 15.9, although still above its long-term average. The dividend yield of 2.0% for the MSCI U.S. Index, meanwhile, is 0.9 standard deviation below its long-term mean.

- Sector returns varied enormously within the MSCI Europe ex U.K. Index. Consumer discretionary stocks (58.8%) shined as groups such as German auto manufacturers and French luxury goods makers ratcheted up sales to emerging markets, while financials (28.0%) lagged given their exposure to the sovereign debt crisis and associated concerns over capital and funding.

- In the United Kingdom, the FTSE® All-Share Index returned 34.8%, nearly matching its continental peers. However, performance received only a minor boost from currency appreciation, as the pound rose "just" 7.3% against the U.S. dollar. Economic growth has stalled in the United Kingdom over the past six months given government austerity measures and a strapped consumer, though it is worth noting that in countries where government spending has not yet been cut back (e.g., the United States), growth has also disappointed. Small caps outperformed large caps (34.1% and 34.0%, respectively), though their fiscal year 2010 outperformance was more substantial (12.2% versus 8.9%).

## Japan

- The 2011 fiscal year got off to a strong start for Japanese equities, as the MSCI Japan Index returned 18.7% during the first half. However, the March earthquake and tsunami reversed some of these gains. Still, the 13.0% return for the fiscal year was a significant improvement from the essentially flat (0.8%) return for the prior year.

- As in other markets, currency appreciation drove most of the gain for offshore investors; local currency investors saw just a 3.1% return for the period.

- For the second straight year, energy (40.7%) and telecommunication services (31.3%) were the best performing sectors, though their contribution was muted by their relatively small weights in the index. Among larger sectors, industrials (21.5%) outperformed despite disappointing export growth and disruptions following the earthquake. Given the meltdown at the Fukushima reactor following the earthquake, Tepco stock plunged and took other utilities (-34.6%) with it.

- Japanese small caps also outperformed for the third straight year, with the MSCI Japan Small Cap Index returning 15.9%, roughly 300 bps better than the main index. Growth stocks returned 15.4% for the year, outperforming value by roughly 470 bps.

## Asia ex Japan

- The MSCI All Country Asia ex Japan Index returned 26.0 in fiscal year 2011, though performance petered out during the second half given concerns about inflation and slowing global growth. Returns were also boosted by the weak U.S. dollar—the index returned 18.2% in local currency terms.

- Performance was driven by developed markets, a reversal from the previous year. Australia (40.9%) and New Zealand (46.3%) led the pack, boosted by currency appreciation against the U.S. dollar of 26.7% and 20.1%, respectively

- Asian emerging markets returned 26.1%, with Korea (43.5%) and Thailand (43.4%) outperforming. China (12.7%) lagged for a second straight year, while India (8.0%), coming off a 32.0% return for fiscal year 2010, also underperformed. Larger Asian emerging markets have suffered from a variety of concerns, including overheating, commodity inflation, and worries (particularly in China) over the health of the banking sector.

- All sectors were in the black for the year, with consumer discretionary (44.0%) again strongly outperforming the broad index. Higher-beta sectors such as materials (43.6%) and energy (32.4%) also fared well, while the heavily weighted financial sector (20.0%) again lagged given concerns with overheating and credit bubbles in countries such as China.

## Emerging Markets

### Equities

- As was the case with other equity markets, emerging markets equities posted strong gains in the second half of calendar year 2010, surging 26.9%. However, markets stalled in the first half of 2011 as price pressures mounted and governments began to tighten policy measures; emerging markets returned only 1.0% for the first half of 2011. For the fiscal year as a whole, emerging markets equities returned 28.2%, but still lagged those of developed markets for the first fiscal year since 2001.

- However, emerging markets maintained their outperformance over the past three-, five-, and ten-year periods. In fact, while roughly one-third of developed markets are in the red over the past five years, all emerging markets are in the black, with aggregate five-year outperformance of about 950 bps on an annualized basis, albeit with sharply higher volatility.

- Emerging markets have returned roughly 170% from their 2008 low, and are a scant 6% below their October 2007 high; developed markets, by contrast, have risen 104% from their 2009 low, and are about 14% below their 2007 peak.

- Among regions, Europe and the Middle East returned 41.1% for the fiscal year, followed by Latin America (26.3%) and Asia (26.1%), while all constituent markets save Egypt (-12.0%) were in the black. All economic sectors also posted gains, with consumer discretionary (46.9%) and materials (34.7%) leading the way, while health care (20.5%) and utilities (16.3%) lagged.

- Emerging markets equities remained fairly valued throughout the fiscal year, and actually saw valuations improve—despite strong price gains—due to soaring earnings, which are now at new peaks. P/E ratios based on return on equity (ROE)–adjusted earnings are in line with their historical average, as is the price-to-book (P/B) ratio of 1.9.

### Debt

- US$-denominated emerging markets bonds returned 11.4% for the fiscal year, their second consecutive year of double-digit returns. Emerging markets bond yields fell by 61 bps for the year, and touched a record low of 5.4% in October. Spreads over ten-year U.S. Treasuries, meanwhile, fell 82 bps to 262 bps, the lowest since April 2010 and roughly 200 bps below their historical average, which is particularly noteworthy considering the low level of Treasury yields.

- Local currency debt also performed well for the year, and even better for US$ investors. The J.P. Morgan Government Bond Index Emerging Markets, which has a duration of about four years, returned 7.9% in local currency terms, but a stout 19.7% in US$ terms thanks to US$ weakness for much of the year.

- The J.P. Morgan Emerging Local Markets Index Plus, which has an average maturity of approximately 60 days, returned 2.7% (14.7% in US$ terms) for the fiscal year. However, the index yield over six-month Treasuries (271 bps), while above its recent low of 155 bps in December 2010, remains well below its historical average of 805 bps. While the yield ratio over six-month Treasuries is 28.1, far above its historical average of 6.0, this is mainly due to the extraordinarily low level of Treasury yields. Thus, returns looking forward are likely to come from currency fluctuations versus the U.S. dollar, as opposed to carry.

## Fixed Income

### Global

- The J.P. Morgan Global Government Bond Index returned 1.2% in local currency terms for the fiscal year, with pronounced US$ weakness adding an additional 9 percentage points of return for unhedged, US$-based investors. Ten-year sovereign bond yields for Germany, the United States, and the United Kingdom rose 43 bps, 21 bps, and 6 bps, respectively.

- The U.S. sovereign yield curve (proxied by the yield spread between ten- and two-year maturities) steepened by 37 bps as economic data soured amid inflationary pressures, yet the German curve flattened by 53 bps as the European Central Bank (ECB) began to hike its policy rate.

- Indeed, the ECB and Bank of Canada both raised rates during the fiscal year, despite disparate economic conditions for the two regions (Canada has an inflated housing market and resource-fueled economic growth, while Europe is split, with Northern countries generally on solid footing, but many peripheral nations in perilous shape). The Fed and Bank of Japan, on the other hand, left policy rates unchanged and initiated "quantitative easing" programs involving securities purchases.

- Corporate bond spreads narrowed during the fiscal year, but remain slightly elevated, while absolute yields are quite low. The option-adjusted spread (OAS) of the BofA Merrill Lynch Global Broad Market Corporates Index fell from 196 bps to 163 bps, while the absolute yield of the index remained unchanged at 3.9% (the post-1997 average yield is 5.0%).

### United States

- The Barclays Capital Aggregate Bond Index returned 3.9% for the fiscal year, with the index's yield essentially unchanged at 2.8%. The credit subindex returned 6.2%, while the government and mortgage subindices returned 2.3% and 3.8%, respectively.

- In November 2010, the Fed launched an eight-month, $600 billion program to purchase intermediate- and long-term Treasury securities (so-called QE2), which wound down at the end of June. Including re-investment of maturing securities, the Fed soaked up about 70% of Treasury issuance for the period.

- U.S. bond mutual fund net inflows totaled an estimated $168 billion during the fiscal year, with taxable bond funds seeing a net cash inflow of $184 billion, while investors *pulled* $30 billion from municipal bond funds. Money market mutual funds, which have had near-zero yields since late 2008, saw a $134 billion decline in assets under management.

- Treasuries returned 2.2% for the fiscal year. Two- to five-year yields fell moderately, while longer maturity yields rose (including a 47 bp spike for the 30-year bond).

- Investment-grade corporate bonds notched another solid year. The Barclays Capital Corporate Investment Grade Bond Index returned 6.3%, while the firm's BBB index returned 7.7% and the high-yield index, 15.6%.

- OAS for the Barclays Capital Corporate Investment Grade Bond Index tightened 40 bps to 153 bps, with yields—which hit more than 9% in October 2008, and have averaged 8.3% since 1973—now just 3.8%. The lowest-rated investment-grade securities tightened the most: the OAS for BBB corporate bonds tightened by 49 bps to 187 bps.

- High-yield OASs tightened even more sharply than investment grade spreads, narrowing from 700 bps to 525 bps. High-yield bonds have averaged a 600 bps OAS over the past ten years, albeit with a wide range; today's lower spreads are likely due mainly to very low default rates and yield-starved investors.

- The Barclays Capital U.S. TIPS Index returned a robust 7.7% for the fiscal year, with real yields of five-, ten-, and 20-year Treasury Inflation-Protected Securities (TIPS) falling 52 bps, 40 bps, and 17 bps, respectively. The five-year real yield briefly flirted with positive territory last summer and at calendar year end, but ended June at -27 bps, while the ten-year real yield closed at 75 bps. The ten-year "breakeven" level of inflation began the fiscal year at 1.8% and ended at 2.4%. The U.S. CPI rose 3.6% during the 12 months ended May 31.

- Despite a gut-wrenching winter downdraft, tax-exempt bonds managed a respectable 3.5% return, soundly topping the return of Treasuries (even on a pre-tax basis). The asset class faced a trifecta of woes during the fall and winter months, with rising yields on long Treasuries, a blizzard of negative muni credit news, and the expiration of the Build America Bonds program. Munis returned -4.6% from November through January, before rebounding in recent months as a supply drought and improving municipal revenues encouraged buyers.

- The Barclays Capital Municipal Bond Index returned 3.5% for the fiscal year, a significant drop from its 9.6% return the previous year. Performance was driven by a second-half recovery, as dire warnings in late calendar year 2010 over a coming surge in defaults failed to materialize. Second-half performance was also helped by declining interest rates and a notable lack of new issuance.

- Returns varied significantly across strategies and sectors. High-yield municipals (5.5%) again outperformed, though by a much smaller margin than during the previous fiscal year. Meanwhile, the sell-off in interest rates late in the 2010 calendar year erased the earlier outperformance of the Barclays Capital 20 Year Municipal Bond Index, which for the fiscal year beat the main index by just 20 bps.

- As noted, one of the dynamics that boosted tax-exempts during the second half was a steep drop in supply, with new issuance for the last six months falling 46% year-over-year. Should borrowing needs increase, or rates back up given the expiry of QE2, recent gains could be reversed.

## Europe

- European bonds (proxied by the Barclays Capital Pan-European Aggregate Bond Index) returned a stunning 17.7% in US$ terms for the fiscal year, although all of the return came from euro and sterling appreciation; the euro-based return was -0.6%.

- German sovereign yields rose during the fiscal year, showing little flight-to-safety boost even as Greece moved closer to a possible default/restructuring. Three-year German bunds saw yields spike more than 1 percentage point, responding in part to ECB policy rate tightening, while ten-year bund yields rose a more modest 43 bps.

- "Peripheral" Eurozone markets, including Greece, Italy, Ireland, Portugal, and Spain, had a dismal fiscal year, with downgrades and sharply rising bond yields for Greece and Portugal. The OAS of Portugal's sovereign debt shot up from 285 to 881 bps, and ten-year Greek government bonds yield about 16%, up from about 10% a year ago.

- Euro-denominated inflation-linked bonds (as represented by the Barclays Capital Euro Inflation-Linked: Eurozone - All CPI Index) returned 21.3% in US$ terms for the fiscal year, though as with nominal bonds the vast majority of the return was due to the euro's bounceback from last summer's lows (the euro-based return for the index was just 2.5%). U.K. linkers (based on the Barclays Capital Global Inflation-Linked: United Kingdom Index) returned 17.2% in US$ terms, also boosted by pound appreciation versus the U.S. dollar, although sterling-based investors saw a very solid 9.2% return.

- Euro- and sterling-denominated investment-grade corporate bond spreads both tightened during the fiscal year. The OAS of BofA Merrill Lynch's Sterling Corporates index narrowed 21 bps to 230 bps, while the BofA Merrill Lynch Euro Corporates Index OAS tightened 32 bps to 169 bps.

### Asia

- Japanese government bond (JGB) yields actually increased slightly during the fiscal year, despite the devastation wreaked by March's earthquake, tsunami, and reactor leaks—ten-year JGB yields rose 5 bps to 1.14%. The J.P. Morgan Japan Government Bond Index returned 10.5% during the fiscal year for the small number of unhedged US$ investors (yen-based returns were 0.8%). The last time ten-year JGBs yielded more than 3% (about the current yield of ten-year U.S. Treasuries) was 1996; since then, JGB investors have earned a respectable 4.6% annualized in US$ terms (although only 2.6% in yen terms), particularly considering the utter lack of Japanese consumer price inflation across the entire period.

- The Barclays Capital Aggregate Asian-Pacific ex Japan Index posted strong returns for US$ investors, but as with many other indices, strength came primarily from appreciation of the Australian dollar and of Asian currencies versus the U.S. dollar. The index returned 22.3% in US$ terms, 7.6% in Singaporean dollars, and -3.5% in Australian dollars.

## High-Yield Credits

### High-Yield Bonds

- The OAS of the Barlays Capital Global High Yield Index narrowed nearly 2 percentage points during the fiscal year—from 707 bps to 516 bps—while the index yield fell from 9.3% to 7.4%. The index returned 18.3% for the year in US$ terms.

- According to Moody's, 2.2% of global speculative-grade issuers defaulted, versus a post-1969 average of 3.8% and 2009 total of 13.1%. Some of the quiescent default picture stems from the ease today in rolling over or refinancing debt that is maturing soon, often at a lower coupon. Of the high-yield bonds in the BofA Merrill Lynch U.S. High Yield Master II Index that were issued within the past year, the median coupon is 8.75, compared to 9.00 for bonds issued between one and four years ago.

- High-yield corporate yields in the United States fell sharply again during the fiscal year, from 9.2% to just 7.3%. Issuance during the fiscal year was a very robust $318 billion. This amount is 20% higher than calendar year 2010's record calendar year issuance total, and is nearly equal to the total issuance from calendar year 2006 through 2008.

### Bank Debt Market

- Bank loans returned 2.6% in the first half of 2011 and 9.4% for the fiscal year, continuing the rally of the last two years, albeit at a slower pace. The market returned 10.2% in 2010 following its dramatic 51.8% return in 2009. For most of 2011, lower-rated credits outperformed the broader market, with companies rated CCC gaining more than 200 bps over the full index. However, this trend cooled significantly in the late spring and early summer as macro concerns returned.

- Secondary market spreads, which peaked in January 2009 at Libor plus 2,363 bps, closed June at Libor plus 550 bps, essentially flat compared to where they started the calendar year.

- Market participants cite several positive factors regarding the bank loan environment at this point: wider than normal spreads, stable recovery rates (72%), low default rates (around 1%), positive corporate performance in cash flow and cost control, a reasonable pace of new issuance, and adequate loan liquidity.

- Defaults as measured by number of issuers declined to 1.5% in the first half of 2011, from peak levels at approximately 8% in late 2009, while defaults in US$ terms declined to 0.9% from the November 2009 peak of 10.8%. The improvement is the result of higher corporate profits and cash flows, the continued ability of bank debt obligors to refinance via the high-yield bond market, and the "amend and extend" phenomenon that has allowed companies to push out maturities. Indeed, the massive maturity wall through 2013 has shrunk by hundreds of billions of dollars in the past couple of years. Although default rates could certainly trend higher at some point, most bank loan investors expect a stable market for the balance of this year.

### Non-Agency Mortgages

- The non-Agency mortgage market remains troubled. Housing starts remain weak, the U.S. government recently ended its purchases of mortgage-backed securities and began selling some of its vast holdings, and the inventory of defaulted or foreclosed properties remains at record levels, suggesting house prices are vulnerable to further declines. While the pace of deterioration in housing metrics has slowed, there is little to indicate the market will bottom anytime soon.

- The non-Agency market now reacts more severely to negative economic news and government action than does the Agency market. Before the credit crisis, this was less true, but given the predominance of floating rate paper and low prices, non-Agency paper now demonstrates little reaction to interest rate movements, but significant response to consumer and employment trends.

- The controversy over bank foreclosures and servicer behavior, meanwhile, continues. It seems likely that banks will be forced to pay massive settlements, modify their practices, and absorb reprimands from regulators while maintaining extremely tight credit standards, thus making it more difficult for middle income borrowers to finance purchases even in a low interest rate environment.

- Still, most market participants see value in distressed residential mortgage–backed securities even after accounting for further home price declines, low prepayments, and high rates of default and foreclosure. New supplies of securities have shrunk, and many view recent price declines as a buying opportunity. However, investors should expect continued volatility in this sector given the stubborn unemployment rate, inconsistent and often harmful government intervention, and the shadow inventory of defaulted properties that will weigh on certain U.S. markets for an extended period.

## Currencies

- The U.S. dollar fell 12.3% in trade-weighted terms over the past 12 months, with the Fed's dollar index reaching post-1973 lows, and the dollar weakening against every major developed currency. While the launch of QE2 in late 2010 helped drive the dollar sharply lower, the dollar has also been hamstrung by faltering economic growth in the United States (likely to further delay any monetary tightening), as well as concerns surrounding the political debate over raising the U.S. debt ceiling.

- Given the sharp decline, we continue to expect a dollar rally at some point as the Fed slows its QE activities and growth outside the United States begins to cool; periods of rising risk aversion should also benefit the dollar. However, sustained U.S. dollar strength will require evidence of a robust U.S. economic recovery amid concrete signs of monetary tightening, neither of which seems imminent.

- The euro rallied 18.4% versus the U.S. dollar for the year, following a series of bailout packages to stem the initial outbreak of the sovereign debt crisis in Europe. The euro also benefitted from its role as the "anti-dollar" amid QE2, with the ECB hiking rates twice in calendar year 2011, while the Bank of England (BOE), the Bank of Japan, and the Fed have remained on hold. However, the currency has again come under pressure as the sovereign debt crisis has flared back up. It remains to be seen whether the ECB will continue to raise rates amid signs of a slowing Eurozone economy.

- The U.K. pound rose 7.3% versus the U.S. dollar, the lowest gain of the major developed markets currencies, and lost ground versus the euro and yen. The pound has been held back by a weakening economy and fiscal retrenchment that has dashed expectations of any near-term BOE tightening.

- The Japanese yen rose 9.6% against the U.S. dollar, reaching an all-time high of USD/JPY 80. The yen has remained firm despite the devastation wreaked by the March earthquake and official interventions to stem the currency's rise, as short-term interest rates remain on par with the United States (i.e., zero), and real rates are positive.

- The Australian dollar surged 26.7% versus the U.S. dollar over the past 12 months, briefly reaching a post-1983 highs of AUD/USD 1.10. While widely considered overvalued, the *Aussie* continues to be supported by rising commodity prices and high interest rates.

- The Swiss franc was the strongest currency we track, rising 28.1% over the past year versus the U.S. dollar. The currency also reached record highs against the euro as investors sought a safe haven from the Eurozone debt crisis.

- Emerging markets currencies also broadly strengthened against the dollar, although less strongly than developed markets currencies, as emerging markets policymakers launched a series of interventions and capital controls to stem the tide of foreign fund flows, in what the Brazilian finance minister termed the beginning of the "currency wars." Over the

12 months to June, an equity-weighted basket of emerging markets currencies rose 10.1% against the U.S. dollar, compared to 15.3% for developed markets currencies.[3]

- The Brazilian *real* was the strongest currency over the past 12 months, rising 15.4% versus the U.S. dollar despite a rash of taxes, interventions, and verbal jawboning by authorities. Other currencies showing strength were the commodity-linked Russian *ruble* (11.9%) and South African rand (13.1%), as well the Korean *won* (14.5%) and Taiwan dollar (11.9%). Laggards included the Indian *rupee* (3.9%), Thai *baht* (5.4%), and Chinese *renminbi* (4.9%), as China continues to pursue a gradual revaluation despite considerable pressure from the United States.

- We remain constructive on emerging markets currencies, as higher interest rates and strong currencies are needed to fight inflationary pressures in many economies. However, emerging markets currencies may be vulnerable in the near term given their recent gains and vulnerability to a global growth scare.

## Hedge Funds

- As was the case for calendar year 2010, fiscal year 2011 was positive for hedge funds, but long/short equity managers had a difficult time keeping up with global equity markets (the Dow Jones Credit Suisse Long/Short Equity Hedge Fund Index returned 13.8% versus 30.7% for the S&P 500). The managers that performed best generally did well on the long side and limited losses on the short side, either through excellent stock picking or (more often) by decreasing short exposure.

- Long/short managers saw the relative outperformance of their long books erode during the market weakness of May and early June. Further, as shorting had continued to be challenging entering the second quarter, many managers had pared short exposure entering the quarter. Some managers have preferred to husband cash by reducing gross exposure and buy the dips rather than increase short exposure.

- Credit and distressed managers have noted a dearth of defaults, creating few opportunities for them to pursue. Meanwhile, rocketing high-yield credits—although attractive shorts from a valuation perspective—have been painful to short given the continued melt up. Credit managers have also been hoarding cash to take advantage of opportunities, and are looking lower in capital structures (sub-debt and post-reorganization equity) and at capital structure trades in the meantime. Those that have outperformed have generally done so on the back of structured credit, both corporate and mortgage structures.

- Risk arbitrage managers, meanwhile, have been hampered by the lack of merger & acquisition (M&A) activity despite what appears to be a ripe backdrop—low rates, tons of cash on corporate balance sheets, lack of organic top-line growth opportunities, and cost synergies fully realized. These managers have also been hoarding cash while pursuing other corporate events—e.g., spin-offs, take-ins, and cross-border activities.

- Open mandate managers have fared better in aggregate than more focused managers by pursuing corporate events and more active engagements in which the manager can drive

[3] A basket weighted along the lines of the MSCI Emerging Markets Index and the MSCI World ex U.S. Index. Effectively, this is the currency contribution to index returns for unhedged US$-based investors.

the outcome—e.g., credit committees and pushing management to use cash for dividend payments or stock buybacks.

- Similarly, multistrategy managers have done relatively well by rotating capital into areas that have seen competition dwindle, such as relative value trades in fixed income arbitrage, statistical arbitrage, and volatility/correlation trades.

- Fiscal year 2011 also helped push the hedge fund industry back to health following the destruction that occurred during the financial crisis. As of the first quarter, total assets invested in hedge funds surpassed $2 trillion for the first time in history (the previous record for industry assets was $1.93 trillion in second quarter 2008), with inflows remaining strong. Strong performance has also helped, of course—at the end of the first quarter, approximately two-thirds of all hedge funds had reached their high-water mark over the past 12 months.

## Commodities

- The S&P GSCI™ Index and the Dow Jones-UBS Commodity Index Total Return returned 26.1% and 25.9% for the fiscal year, respectively, bringing their five-year average annual compound returns (AACRs) to -6.2% and -0.05%. Commodity prices (along with risk assets in general) rose substantially after the Fed presaged its second round of quantitative easing in August.

- The S&P GSCI™ Spot Index ended the fiscal year 42.4% above its post-1969 inflation-adjusted average; while this is considerably below its November 1974 peak of 187.8% above the mean, it is also far above its December 1998 low of 62.2% *below* the mean.

- Within the Dow Jones-UBS Commodity Index, the energy subindex lagged, returning just 2.1%. The poor performance was largely attributable to the negative roll yield, which had a particularly pernicious impact in the heavy-weight natural gas and oil markets—the roll return for the Dow Jones-UBS Commodity Index Total Return was -7.1% over the last 12 months. Many commodities outside of the energy sector have also been in contango for several years.

- Crude oil prices, as measured by the West Texas Intermediate (WTI) near month oil futures contract, began the fiscal year at $75.7/barrel (bbl) and reached $113.7/bbl in late April before ending at $95.1/bbl. Major global events, including civil unrest and regime change in the Middle East and North Africa (MENA) region, the loss of Libya's oil production, and the release of strategic petroleum reserves by the United States and other developed countries, caused significant volatility.

- Prices for similar grades of crude oil diverged over the fiscal year. The spread between Brent crude oil and WTI, which historically has been around $1, averaged about $7 over the last 12 months and around $13 for the last six. Disruptions in supply chains and logistical concerns surrounding the delivery point for the NYMEX WTI contract in Cushing, Oklahoma, have caused WTI to trade at a steep discount to Brent, despite WTI's moderately higher quality. Given these concerns and their likely persistence, Brent has begun to replace WTI as the benchmark global crude oil contract, although WTI remains the sole crude oil contract included within the Dow Jones-UBS Commodity Index.

- Natural gas prices continue to be hamstrung by oversupply. Despite falling spot prices, rig and drilling activity decreased only slightly during the fiscal year. This has been attributed to several factors: the amount of time required to drill shale gas has fallen dramatically, which has reduced costs; the concomitant production of natural gas liquids, such as propane, ethane, and butane, has pushed breakeven costs lower; drilling continues in order to hold onto land leases; and many companies have implemented commodity hedges to protect their cash flow and/or formed joint ventures with larger companies to gain access to capital.

- The precious metals subindex returned 35.1% for the fiscal year, in large part due to silver, which surged 86.9%, compared to gold's relatively pedestrian 21.5% increase. Silver began the fiscal year at $18.74/troy ounce and rose steadily all the way to $48.70 on April 29, ultimately closing the year at $35.02.

- The agriculture subindex climbed 49.0%. Among the grains, corn prices rose 99.2% to $6.62/bushel and wheat, 49.3% to $6.60/bushel, although both remain below 2008 highs. Falling yields and adverse weather conditions have boosted grain prices, and global demand continues to be strong, although early July reports of larger-than-expected corn plantings pushed prices down sharply after the end of the fiscal year. Cotton, too, has had a huge run in the last year, climbing from 77.3 cents/pounds (c/lb) last June to 210.6 c/lb on March 7, and settling at 132.2 c/lb on June 30, up 71.0% for the year.

- The industrial metals subindex increased 30.7%, with strong gains for tin (49.5%), copper (45.2%), and aluminum (28.3%). Anecdotally, China accounts for 38.9% and 40.6% of global copper and aluminum consumption, respectively.

- Over the last five years, the best-performing sector in the Dow Jones-UBS was precious metals, which posted a five-year AACR of 20.5%, while energy (-18.2%) did the worst. The negative roll yield weighed heavily on the index's results, with a -11.6% AACR, while the spot price index posted a 10.8% AACR.

## Natural Resources Equities

- Natural resources–related equities (as proxied by the MSCI World Natural Resources Index) returned 43.8% for the fiscal year, topping the MSCI World's 30.5% return in US$ terms. The MSCI World Natural Resources Index also outpaced the 35.0% rise in commodities spot prices for the year.

- Shares were particularly strong in September and December, posting greater than 10% gains in both months. Concerns about whether China's tightening monetary policy will slow the country's commodity demand have been largely shrugged off by investors until recent months.

- Energy shares returned 46.3% in unhedged US$ terms for the fiscal year, while mining and metals firms returned a similarly impressive 38.8%.

- Share prices of natural resources equities have risen sharply, and equities are now overvalued. While prices of the underlying commodities that these firms extract are elevated, thus supporting strong earnings, the equities are vulnerable to any shakeout in the commodity market or broad equity market pullback. Further, the high degree of operating leverage with which many natural resources equity firms operate may exacerbate their vulnerability to downward pressure in underlying commodity prices.

- While valuations are elevated, we still recommend investors include natural resources equities in inflation-sensitive allocations due to the implementation challenges of commodity futures.

## Private Investments in Oil, Gas and Other Energy

- The Cambridge Associates Energy Upstream & Royalties & Private Equity Energy Index generated average internal rates of return for the one-, three-, and five-year periods ending December 31, 2010, of 18.8%, 6.6%, and 13.7%, respectively.

- Volatility has been the norm during the first half of 2011, as unrest in the MENA region raised supply concerns and pushed global oil prices over $100/bbl, while the Japanese earthquake/tsunami caused prices to pull back a bit. Transaction activity has been robust, as capital markets thaw and companies continue to look to gain exposure to coveted unconventional resource plays.

- Natural gas prices, as measured by the Henry Hub spot price, averaged $4.3 per MMBtu in May, up 1.6% from April. While prices have rebounded from October lows, they continue to trade at low levels thanks in part to robust supplies from unconventional resource plays such as the Marcellus and Haynesville shales.

- Many U.S. exploration & production companies have accelerated capital expenditures in the face of weak natural gas prices, with an emphasis on developing oil reserves. The U.S. rig count is up 23% year-over-year, thanks mainly to increases in unconventional drilling activity, as evidenced by the 32% rise in the horizontal rig count. Rigs issued for new oil wells, meanwhile, increased 76% as oil prices rose. The large price difference between petroleum-based liquids and dry natural gas prices on an energy-equivalent basis is causing many producers to redirect new drilling capital expenditures to liquids-rich unconventional shale basins such as the Eagle Ford in Texas and the Bakken in North Dakota.

- Business activity in the U.S. oilfield service sector continued to benefit from the increase in rig count. Companies focused on horizontal drilling and completion services are in high demand as developments in technology allow for a greater number of staged fracking zones per well. Year-to-date, the Oil Service Sector Index—a group of public companies that assist in the production, processing, and distribution of oil & gas—has risen 5.7% through June 6. Non-U.S. oilfield service companies tend to have greater exposure to the oil sector, and have thus benefitted from the rebound of oil prices and increase in non-U.S. oil production.

- A number of investment firms have launched new private equity energy funds: Alliance Bernstein, Apollo, Barclays Capital, Blackstone, Goldman, Sachs & Co., Kohlberg Kravis Roberts & Co., and Och-Ziff are all either currently fund raising or expected to raise funds later in 2011. This will likely increase competition for both oil & gas assets and experienced management teams. Anecdotally, we are aware of two recent examples where these new players substantially bid up deal terms to entice successful management teams to not re-up with their existing private equity sponsor, and instead partner with the new entity.

## Timber

- The NCREIF Timberland Index returned -0.9% for the four quarters ended March 31, but still generated a ten-year AACR of 6.9%. After recording a modest gain in 2010, timber prices trended down in the first quarter.

- Timber supply has been relatively contained, with North American year-to-date lumber production below its 2006 peak, albeit ahead of last year's levels. Further constraints on supply include the pine mountain beetle devastation in British Columbia and reduction in Russian exports due to its 25% log export tax. As a result, prices could rise for both hard and softwoods, particularly if Chinese demand for softwoods and European demand for U.S. wood pellets (for biomass) stays strong.

- An improved timber price environment is reflected in last year's recent income return data. The trailing 12-month yield on the NCREIF Timberland Index ended its 16-quarter decline in first quarter 2010 and also posted gains in the following four quarters, while its yield, which fell from 5.6% in 2005 to 1.5% at the end of 2009, rose to 2.6% at the end of the first quarter.

- While the bid-ask spread remains wide—as most sellers are not distressed, while buyers are unenthusiastic given the tenuous state of the U.S. housing market—transaction volume has ticked up from an anemic 2010.

## Venture Capital and Private Equity

### U.S. Venture Capital

- U.S. venture capital funds returned 5.0% in the first quarter and 18.5% for the one-year period ended March 31, according to the Cambridge Associates LLC U.S. Venture Capital Index®. We expect the returns for U.S. venture capital managers for fiscal year 2011 to be between 19% and 20%, based on estimated returns for second quarter 2011 of between 1% and 2%.

- Venture capital fund raising, which has slowed dramatically since the middle of 2008, is showing signs of life due to the improvement in public markets and the venture-backed exit environment; many firms that postponed fund-raising activity in 2009 and 2010 have 2011 fund-raising schedules. However, second quarter figures were much lower than first quarter, suggesting 2011 may not be as strong as initially expected. A smaller number of firms are also garnering a greater share of funds.

- Venture capital firms raised $2.7 billion across 37 funds in the second quarter, a 28% year-over-year increase in dollars but 23% decline in the number of funds, according to the National Venture Capital Association (NVCA). While first quarter figures were robust at $7.6 billion raised by 42 funds, three multi-billion dollar funds drove the dollar amount. In 2010, venture capital firms raised $13.3 billion across 162 funds, the third consecutive year of decline and slowest since 2003. The recent high-water mark was 2007, when 233 funds raised $30.7 billion.

- Disclosed median pre-money valuations across stages and sectors rose slightly to $20.2 million in the first quarter, up from $19.9 million in the prior quarter and $13.0 million in first quarter 2010, but well below their 2008 peak of $25 million. However, anecdotal evidence suggests an even sharper rise in valuations. The relatively high valuations of recent financings in high-profile companies are beginning to impact valuations more broadly. For example, late-stage technology has become highly competitive—in the first quarter, disclosed valuations for late-stage information technology deals rose to about $44 million, from about $31 million in 2009.

- The initial public offering (IPO) market showed strong activity in the second quarter, driven by several consumer Internet companies. There were 22 venture-backed IPOs in the quarter with a total offer amount of $5.5 billion, with information technology, and Internet companies in particular, accounting for roughly two-thirds of activity. Post-IPO performance has also been good, in line with rising public markets. Of the 22 IPOs in the second quarter, 15 were trading at or above their offering prices as of June 30.

- Still, M&As remain the most popular exit strategy for venture-backed companies. The second quarter saw 79 venture-backed M&A deals (36 with disclosed values) with a total disclosed value of $5.4 billion, according to the NVCA, compared to 99 venture-backed M&A deals with a total disclosed value of $3.0 billion in second quarter 2010. M&A activity for 2010 as a whole topped that of both 2008 and 2009, with 436 deals (129 with disclosed values) with a total disclosed value of $18.8 billion, compared to 273 deals with $12.5 billion of disclosed value in 2009, and 348 deals with $13.9 billion of disclosed value in 2008.

## U.S. Private Equity

- We continue to view U.S. private equity (buyouts and growth equity) as overvalued. Two years into what has been a tepid economic recovery, a lower interest rate environment and the search for yield have fueled a rapid recovery in private equity volumes from their 2009 lows, increasing leverage and, therefore, acquisition multiples.

- The continued capital overhang (committed capital raised in the last five years yet to be invested), meanwhile, also creates pressure for private equity managers to put money to work or return it to investors. As of December 31, Cambridge Associates estimated half of the capital raised from 2005 to 2010 had been called, leaving a $376 billion overhang net of fees. Not surprisingly, more than 60% was concentrated in the 2007 and 2008 vintages, with most at funds with more than $1 billion in commitments. Despite a meaningful reduction in the overhang for large funds over the last year, the current overhang appears too large to be absorbed by anything other than a replay of the easy credit–powered 2005–08 deal environment.

- U.S. leveraged buyout deal volume picked up in 2010 from its 2009 low, but remains below its historical average and much lower than peak levels. In 2010, 274 deals worth $71.1 billion were announced, up almost three times by value from 159 deals worth $23.9 billion in 2009. However, this is still below the post-1994 average annual pace of 280 deals representing $86.1 billion, not to mention the peak years from 2004 to 2007, which averaged 541 deals representing $241.0 billion. Leveraged buyout (LBO) activity in the first half of 2011 was approximately 50% of *total* 2010 activity by value and number (i.e., on a similar pace).

- Credit markets have reopened, as reflected by increased issuance of U.S. leveraged loans and high-yield debt. U.S. leveraged loan issuance for 2010 was $511.4 billion, 86% more than the 2009 total of $275.2 billion, while first-half 2011 issuance totaled $473.2 billion, 93% more than the year-earlier period. High-yield debt issuance, meanwhile, reached record volumes of $217.5 billion for 2010, about 66% ahead of 2009 levels, and first quarter 2011 issuance was $67.3 billion, the most in any quarter since 1995 (when our data begin). Much of the capital was used to extend debt maturities and refinance loans at attractive pricing, as opposed to doing new deals.

- The average leverage multiple for transactions completed in 2010 was 4.6 times, up from a recent low of 3.7 times in 2009. Leverage multiples have continued to trend up, with an average of 4.8 times for transactions completed in the first half of 2011, above the 14-year historical average of 4.5 times.

- 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.

- Exit opportunities, meanwhile, continue to pick up but remain below historic activity levels. According to Dealogic, the dollar value of U.S. M&A activity in 2010 was $898.2 billion, above 2009's $802.0 billion, but below the annual average of $1.0 trillion since 1995. First half 2011 M&A activity totaled $586.6 billion, a 41% increase from the prior-year period and up 21% from second half 2010. Private equity transactions represented 10.5% of total 2010 M&A volume and 7.7% of first half 2011 volume.

- While the U.S. IPO market has also picked up from its 2009 low, it remains below historical averages. There were 171 IPOs raising $44.6 billion in 2010, including 65 IPOs totaling $28.1 billion in the fourth quarter. This is significantly higher than the 64 IPOs that raised $27.1 billion in 2009, but below the post-1994 annual average of 306 IPOs raising $53.0 billion. At the recent 2007 peak, 288 IPOs raised $65.4 billion. Private equity–backed IPOs in 2010 accounted for 35% of IPOs by number and 37% of capital raised, on par with the 2005–07 pace and above historical averages. For the first half of 2011, 95 IPOs raised $30.3 billion, a slight decrease from the second half of 2010, but significantly eclipsing the prior-year period by capital raised and by number.

- U.S. private equity funds returned 5.4% in the first quarter and 21.5% for the one-year period ended March 31, according to the Cambridge Associates U.S. Private Equity Index®. We expect returns for U.S. private equity managers for fiscal year 2011 to be between 22% and 23%, based on estimated returns for second quarter 2011 of between 2% and 3%.

- Fund-raising activity for U.S.-based venture capital, private equity, and mezzanine firms in 2010 was on par with 2009 by number of funds raised and slightly lower by capital commitments. For the calendar year, 336 funds raised $86.4 billion, compared to 2009, when firms raised $95.8 billion across 331 funds. Fund raising for 2010 represents a 31% decrease (in dollars) from 2008, and a 64% decrease from 2007. Many managers that had pushed out fund raising, given a slower-than-expected investment pace for existing funds and the liquidity-constrained limited partnership community, are, or will likely be, in the market in the next 12 months. Through second quarter 2011, 202 funds have raised $64.8 billion, 36% greater (in dollars) than the prior-year period.

## European Venture Capital and Private Equity

- Western European non-venture private equity valuations continue to remain overvalued, especially on the higher end of the market.

- While debt markets have stabilized in 2010 and banks are willing to lend again for large transactions, investors still have to contribute a larger part of equity to secure debt financing. According to Standard & Poor's LCD, equity contribution averaged 46.2% for European LBOs in the first half of 2011, compared to only 32.5% at the peak of the market in 2007. Buyout activity declined in the first quarter, following consistent growth in 2010. According to Incisive Media's *unquote" Private Equity Barometer Q1 2011*, volume and value totaled 92 deals and €10.8 billion in the first three months of 2011, decreases of 16% and close to 50%, respectively, from the prior quarter.

- Investors have bid for deals aggressively, with fierce competition in the large-/upper-middle-market segment driven by a capital overhang that needs to be invested over the next two to three years. Interestingly, many of the deals we have seen have been sponsor-to-sponsor buyouts.

- European venture capital looks fairly valued, as early- and late-stage valuations have stabilized at reasonable levels for all but the most sought-after deals, and we do not see any capital overhang.

- Early- and late-stage valuations have stabilized at reasonable levels for all but the most sought-after deals, particularly in the digital media space, where some U.S. investors perceive value compared to U.S. companies. European venture managers appear to be suffering from a dearth of opportunities in most sectors. According to Incisive Media's *unquote" Private Equity Barometer Q1 2011*, the number of investments in European venture-backed companies was 42 in the first quarter, compared to 47 in fourth quarter 2010, while value dropped 17% to €247 million; compared to first quarter 2010, totals for volume and value fell by 33% and 8%, respectively.

### Asian Venture Capital and Private Equity

- We view Asian venture capital and private equity in many segments as overvalued, although some situations remain fairly valued. In China, the combination of fund inflows, both in *renminbi* and U.S. dollars, and rising equity markets has pushed asking P/E multiples into high double digits for most growth equity deals. In developed Asia, recent buyout transactions were completed at double-digit enterprise value–to-EBITDA ratios, with leverage accounting for 50% to 60% of transaction value.

- Asian private equity funds raised US$33.6 billion of fresh capital in 2010, a 33% increase compared to 2009, with US$27.2 billion going to non-buyout funds, according to data released by the *Asia Private Equity Review*. Chinese funds accounted for US$20.1 billion, or 60% of the total.

- Capital deployment in Asia surged in 2010, with US$30.2 billion invested, a 50% increase from 2009. Growth/expansion deals accounted for US$17.0 billion, and buyouts and control transactions the rest. China also dominated this area, accounting for 32.4% of transactions (US$9.8 billion), followed by Australia (US$7.4 billion) and India (US$5.6 billion).

## Private Real Estate

### United States

- According to NCREIF, private investments in U.S. commercial property returned 3.9% in the second quarter, as capital values rose by 2.4%. The Moody's/REAL Commercial Property Price Index rose 6.3% in May, the largest gain since the index began measuring U.S. commercial property prices in 2000. The index is down 11% year-over-year and 46% below the peak of October 2007. The market also remains extremely bifurcated, with significant appreciation for institutional-quality assets in major metropolitan markets, but stagnant prices for lower-quality assets (i.e., those in secondary or tertiary markets).

- While vacancies are improving, they remain near record highs in the office, industrial, and retail sectors, and owners may not be able to raise rents until 2012 or 2013.

- Transaction volumes, meanwhile, remain well below pre-crisis levels, although investment activity has steadily increased since bottoming in second quarter 2009, with deals focused on very high-quality, income-generating assets in major cities. Indeed, three cities have seen sharp cap rate compression for trophy office assets—New York, Washington, D.C., and San Francisco. According to the MIT Transactions-Based Index, meanwhile, commercial real estate values derived from NCREIF data dropped 27.9% from their second quarter 2007 peak through first quarter 2011.

- Following a two-plus-year drought in the availability of real estate financing, many lenders are active today, and particularly willing to lend versus trophy assets in core markets. Life insurance companies were the first to return to the market, followed by banks. However, while balance sheets for the largest banks have recovered since the depths of the crisis, much of this is due to lower loan loss provisions, which could have repercussions in another downturn. The commercial mortgage–backed securities sector, which accounted for 28% of outstanding mortgage debt in 2007, is also increasingly active. Issuance for the first four months of 2011 was roughly three quarters of that for 2010 as a whole, according to JLL.

- Many potential buyers have been disappointed with the lack of distressed sales to date, as banks have generally chosen to extend maturities with borrowers still making regular interest payments, regardless of underlying property value. In our opinion, such actions have merely pushed the cycle into the future; further, absent a robust economic recovery, these extensions will almost certainly exacerbate the cycle when it arrives. Recent transaction activity has revealed that the extend and pretend phase may be coming to an end, as more lenders now have the financial strength to take a tougher stance with borrowers and withstand losses on their balance sheets.

### Europe ex U.K.

- A degree of stability has returned to most European real estate markets after the crisis of 2009. Generally, prime office rents were unchanged or slightly higher in the first quarter, a sign the broader market may be stabilizing. Of course, such a bottoming will depend on economic conditions, which remain tenuous.

- Indeed, while most property markets have stabilized with respect to vacancy and rental rates, debt and employment markets are expected to remain sluggish for some time given concerns over European fundamentals broadly, and the fiscal crisis surrounding peripheral Eurozone members (Greece, Portugal, Spain, etc.).

- Overall, 2010 transaction volumes were up 40% from 2009, with €113 billion in total European investment, according to Real Capital Analytics. Prime yields have begun to stabilize and even contract, with Germany, Paris, and the Nordic markets seeing some yield compression.

- Still, transaction markets remain bifurcated, with strong interest for stabilized, cash-flowing assets located in major markets, but less so for riskier assets and/or properties generating little or no cash flow. As a result, there are likely attractive options for investors with the ability to address physical or capital structure deficiencies and rebuild an asset's cash flow stream.

### United Kingdom

- Real estate fundamentals are improving, with rents stabilizing as capital flows back into London, attracted to assets with decent yields and the weak pound sterling.

- The transaction market, meanwhile, remains bifurcated—as in the United States and continental Europe—with much stronger demand for prime properties than for secondary properties with less dependable cash flows. As a result, prime yields remain low in both the City and West End districts, with pricing close to peak 2007 levels, while outside of such locations, concerns about prolonged weak fundamentals prevail, and investor demand remains weak.

- First quarter vacancy in the West End stood at 6.0%, the lowest since fourth quarter 2008. Prime headline rents rose 6% during the quarter, to £90 per square foot, while prime yields remained at 4%. With new development limited, observers expect vacancy to continue to decline and rents to rise, according to Knight Frank.

- First quarter vacancy in the City was 8.4%, while prime rents remain unchanged from last year at £55 per square foot. Transaction volume totaled £1.4 billion in the first quarter, double that of the year-ago period, while yields stayed at 5.25% for the fourth consecutive quarter.

- Transaction volume in the Central London market was £3.4 billion in the fourth quarter, the highest in three years, then fell back to £2.1 billion during the first quarter. Foreign investor demand has been strong, while domestic institutions have cautiously re-entered the market. In addition, private equity and opportunistic investors are focused on distressed sales.

### Asia

- Prime commercial properties in Asia have nearly rebounded to pre-crisis levels, with low interest rates and increasing overseas investment demand from Chinese private investors causing surges in luxury residential prices in Hong Kong, Macau, Singapore, and Taiwan. Similarly, domestic residential demand in China, particularly in Tier 1 cities, remains strong despite government measures to curb appreciation.

- Strong economic growth, record low interest rates, and increasing demand from Chinese investors all contributed to a 25% to 40% surge in luxury residential prices between the end of 2008 and the end of 2010 in Greater China and Singapore, according to Invesco. In Singapore and Hong Kong, residential prices have rebounded to pre-crisis levels. Governments in both countries have responded with a series of cooling measures to clamp down on residential property speculation, including graduated stamp duty taxes to discourage short-term speculators. Still, according to JLL, luxury residential prices in Hong Kong rose by 8.3% in the first quarter, even though sales volume fell 10%. Similarly, luxury residential prices in Singapore rose by 1.5% in the first quarter, and some boutique projects in prime areas have achieved near-100% pre-sale rates within one to two months of launching.

- CB Richard Ellis reported $14.4 billion of commercial real estate was bought and sold in the first quarter, slightly lower than the prior quarter but still close to pre-crisis levels. Japan accounted for 37% of total transacted volume in Asia Pacific, followed by Singapore (19%), China (18%), and Hong Kong (9%), with the lower interest rate environment and liquidity injection by the Bank of Japan boosting J-REITs and domestic companies. Some foreign investors—many of whom have been priced out of the prime office market by the J-REITs—have started to invest in medium-sized, Grade B properties. JLL reported the Tokyo Grade A office vacancy rate rose slightly to 5.9% in the first quarter, but was still below its year-ago level. According to Invesco, prime property yields in Asia compressed between 100 bps and 200 bps in 2010, while core office property yields in Asia Pacific gateway cities are at similar levels to borrowing rates. This will constrain capital values going forward, as growth was primarily driven by the low interest rate environment during the last 18 to 24 months.

- In mainland China, ample liquidity and low interest rates have buoyed residential property prices, particularly in Tier I cities, while office demand and pricing have also been robust as growing Chinese institutions soak up new development. Grade A office properties in both Beijing and Shanghai reported 5.1% and 8.8% quarter-over-quarter rental growth in the first quarter. Despite various government measures to cool economic growth, Tier I property markets show no signs of slowing down. Indeed, increased demand from domestic life insurance companies has driven cap rates of Grade A office properties in Tier I cities in China to 4% to 5%, approximately 100 bps of cap rate compression in 12 months.

- An increasing number of mainland tourists to Hong Kong has driven retail sales and the expansion of luxury brand operators. Most notably, LVMH paid US$360 per square foot per month for prime ground retail space in Causeway Bay. Emperor International Holdings also purchased a 600 square foot prime ground floor retail space on Percival Street in Causeway Bay for a record sum of US$49 million (US$81,400 per square foot). According to JLL, more F&B operators will have to relinquish their premises to make way for high-end retailers, with high-end retail rents in projected to rise 12% to 15% in 2011.

## Global Real Estate Securities

- Global property securities, as represented by the FTSE® EPRA/NAREIT Developed Real Estate Index, returned 33.4% for the fiscal year, the index's second-best fiscal year on record and second consecutive year of very strong performance. At fiscal year-end, global property stocks had returned nearly 175% since March 2009, though the global index remained 22.3% below its February 2007 peak.

- Europe was the best-performing region for the year, with the FTSE® EPRA/NAREIT Europe Real Estate Index returning 54.9%. Country returns ranged from Spain's -46.0% to Finland's 76.7%, with the heavyweight U.K. and France markets returning 51.1% and 59.8%, respectively. European markets received a strong tailwind from currency fluctuations, as the euro and pound climbed 18.4% and 7.3% against the U.S. dollar.

- The FTSE® EPRA/NAREIT North America Index returned 35.3%. U.S. REITs returned 34.3%, while the smaller Canadian market returned 45.0%. Falling yields continued to be a key driver of U.S. REITs' strong performance: spurred by cheaper costs of capital, implied cap rates fell more than 100 bps to just under 6%. However, a bottoming in property fundamentals in the back half of 2010, as well as expectations of improving net operating income across all property sectors in 2011, also contributed to rising share prices.

- Developed Asian property securities returned 22.8% for the fiscal year, despite a series of government policy measures that weighed on the development-heavy Hong Kong and Singapore property securities markets over the final eight months of the year. Hong Kong and Singapore returned 17.8% and 12.8% for the fiscal year, respectively, but ended the year 12.9% and 10.3% below their November highs. Elsewhere in Asia, the Japanese earthquake and tsunami cut short a strong rally in Japanese property stocks: after climbing 38.4% through mid-March, the market lost 17.5% during the first two days of the post-earthquake trading session, before recovering to finish the year up 25.8%. Australia was the best-performing major market in the region; however, its 34.2% return was largely attributable to an appreciating Australian dollar (Australia returned 5.9% in local currency terms).

- Global property securities valuations were relatively stable over the course of fiscal 2011, ranging between a 14% discount-to-net asset value (NAV) and parity with NAV, as share price gains more or less corresponded to NAV growth in aggregate. The global universe ended the year at a 7.6% discount. However, this relatively narrow valuation range continues to mask a striking divergence in the valuations of owner/operator and development business models. Specifically, landlords generally traded within 5% of NAV throughout the year, while developers have traded at more than a 30% discount since November. Among major property markets, the United States remained the most expensive (17% premium) at year end, while Japan (36.6% discount) and China (38.0% discount) were among the cheapest.

- North America has been the best-performing region over the past three- and five-year time horizons, producing AACRs of 5.3% and 2.7%, respectively, while Asia has returned 0.0% and 2.3%. Europe's strong showing in fiscal year 2011 was not sufficient enough to pull it ahead of Asia over either interval: the European regional index posted AACRs of -0.2% and -2.0% over three and five years, respectively, weighed down by the poor performance of the U.K. market. ■

**Exhibit 1**

## Comparative Performance of Various Capital Markets

Fiscal Years 2010 and 2011 • U.S. Dollar

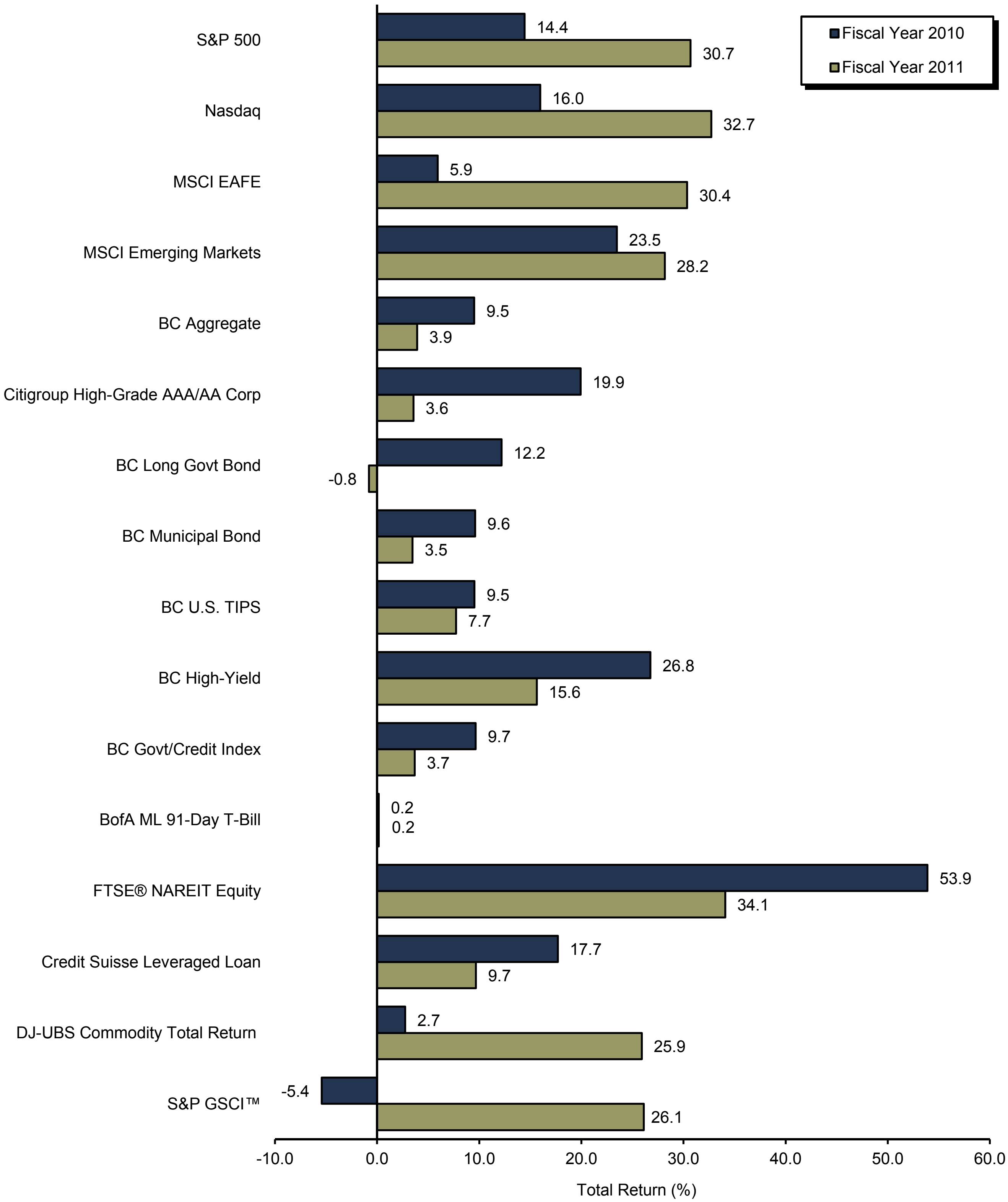
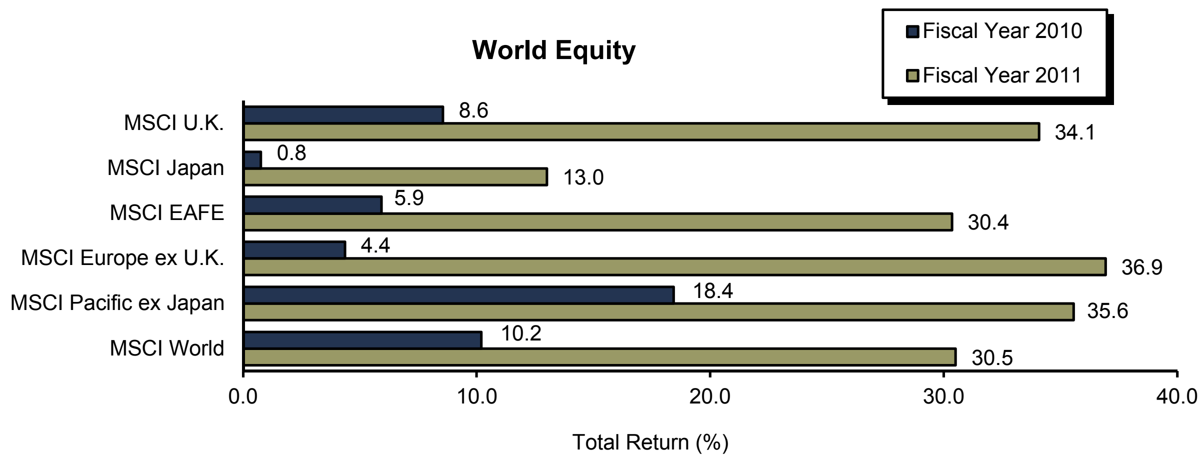
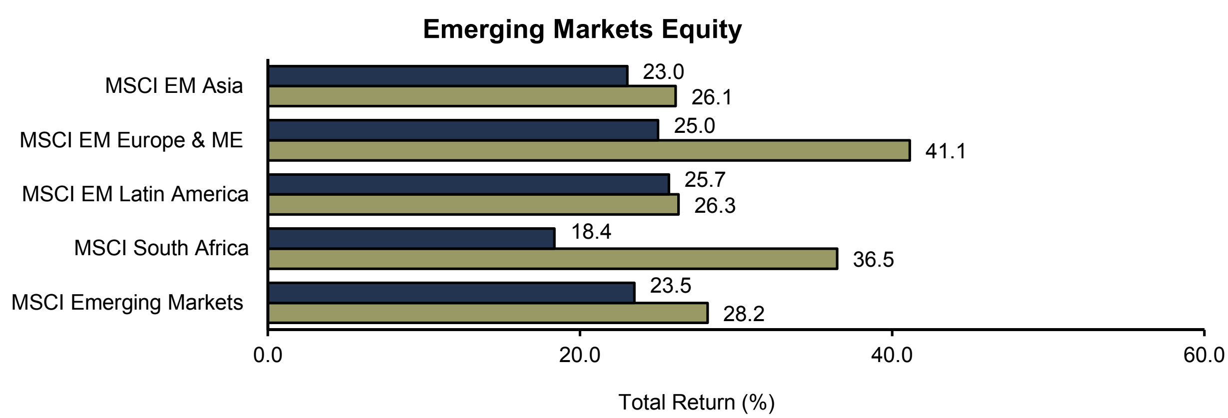


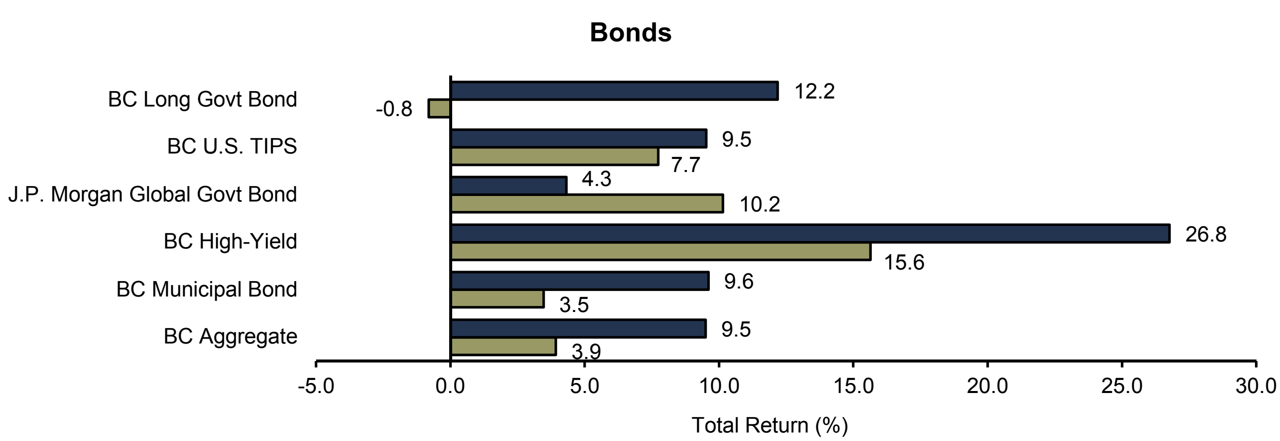
**Exhibit 1 (continued)**

## Comparative Performance of Various Capital Markets

Fiscal Years 2010 and 2011 • U.S. Dollar




Sources: Barclays Capital, Bloomberg L.P., BofA Merrill Lynch, Citigroup Global Markets, Dow Jones & Company, Inc., FTSE International Limited, J.P. Morgan Securities, Inc., Merrill Lynch & Co., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, 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. Fiscal year begins July 1 and ends June 30.

**Exhibit 2**

## Comparative Performance of Various Capital Markets

Fiscal Year 2011 • U.S. Dollar

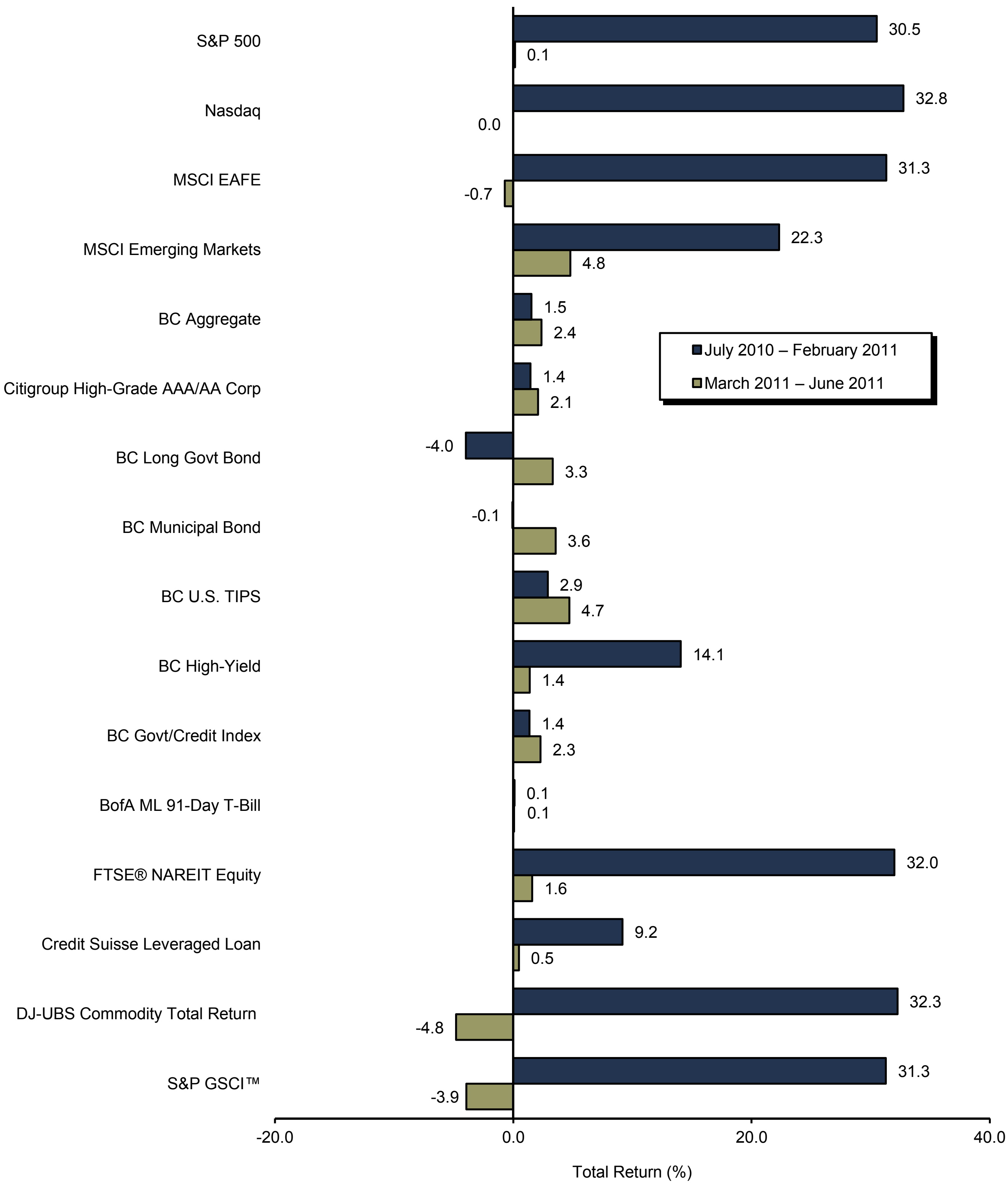
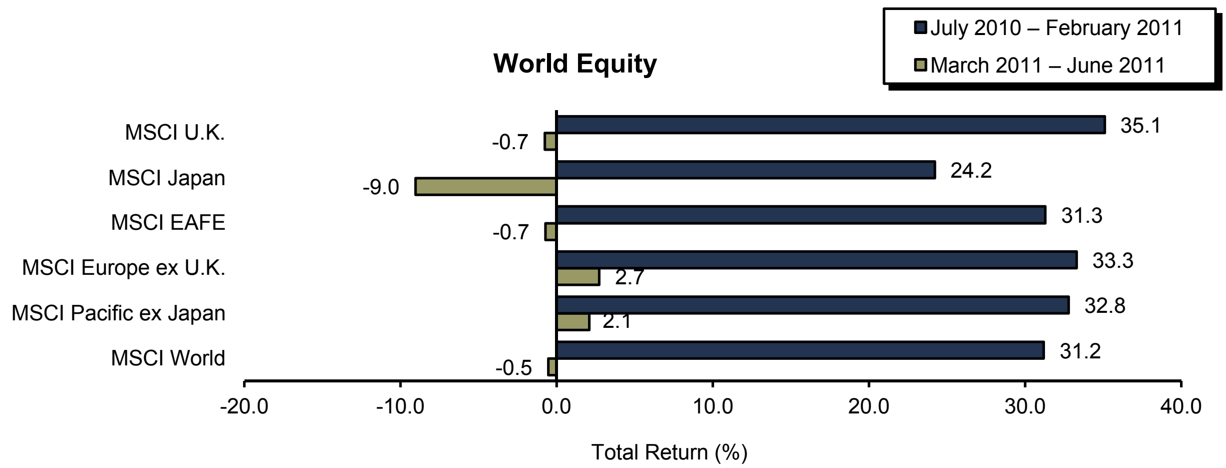
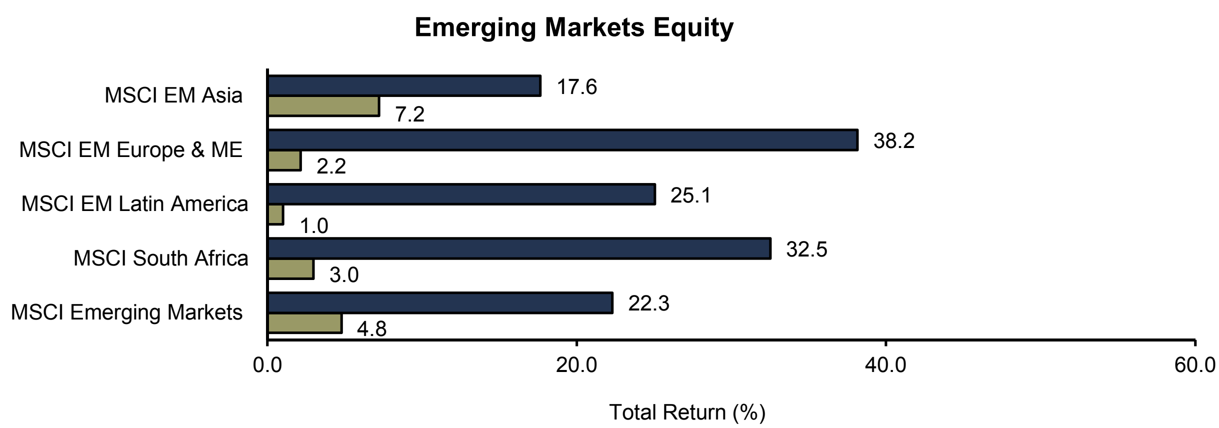


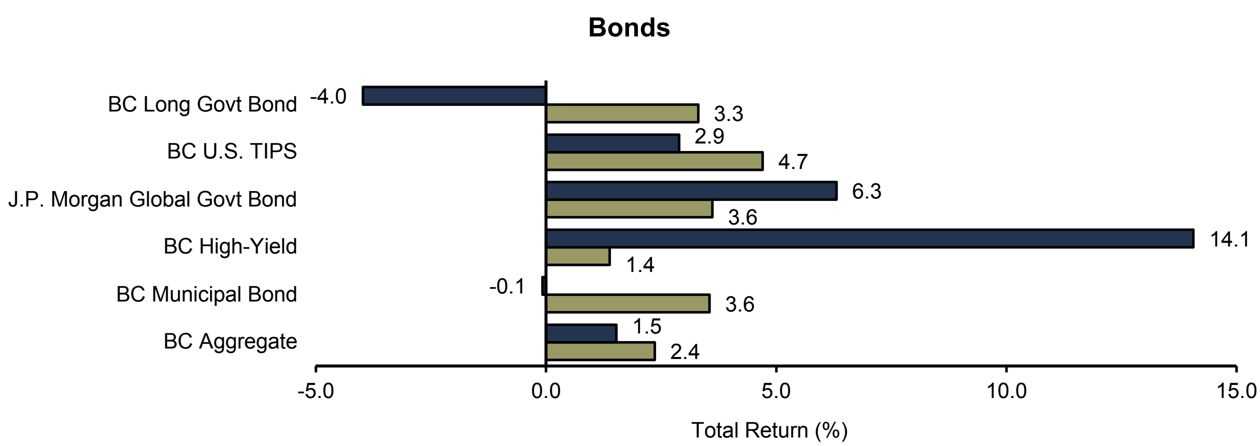
**Exhibit 2 (continued)**

## Comparative Performance of Various Capital Markets

Fiscal Year 2011 • U.S. Dollar



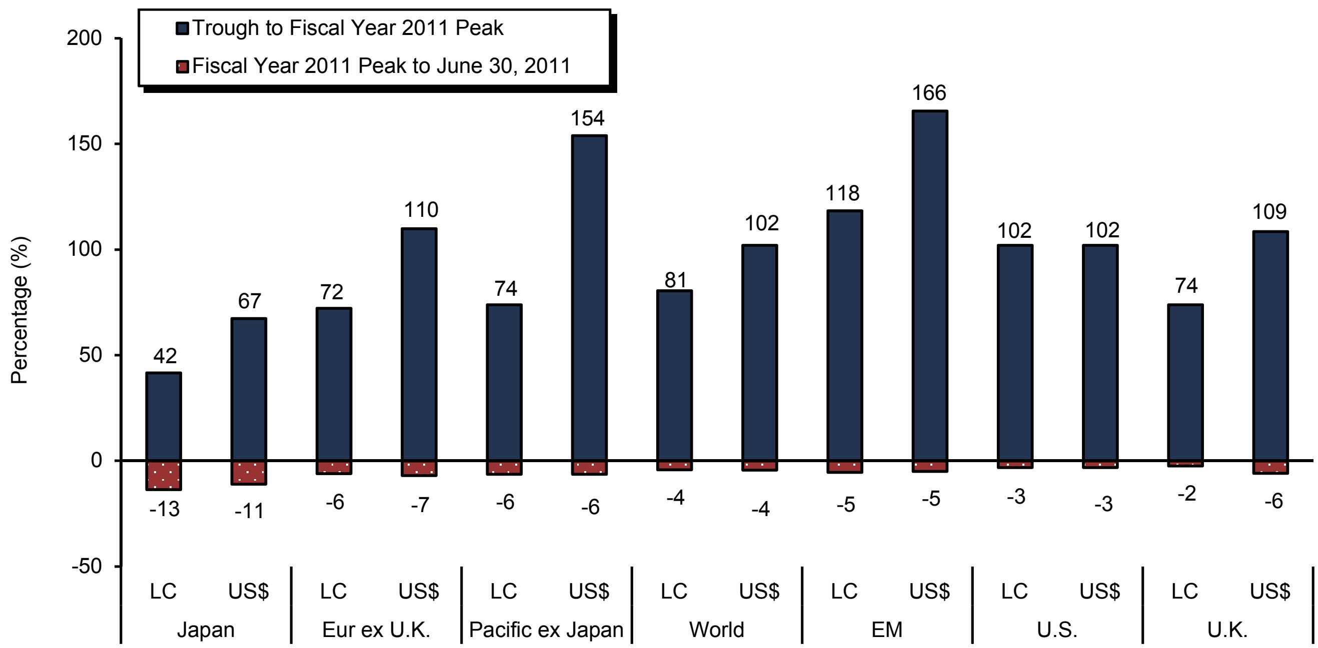



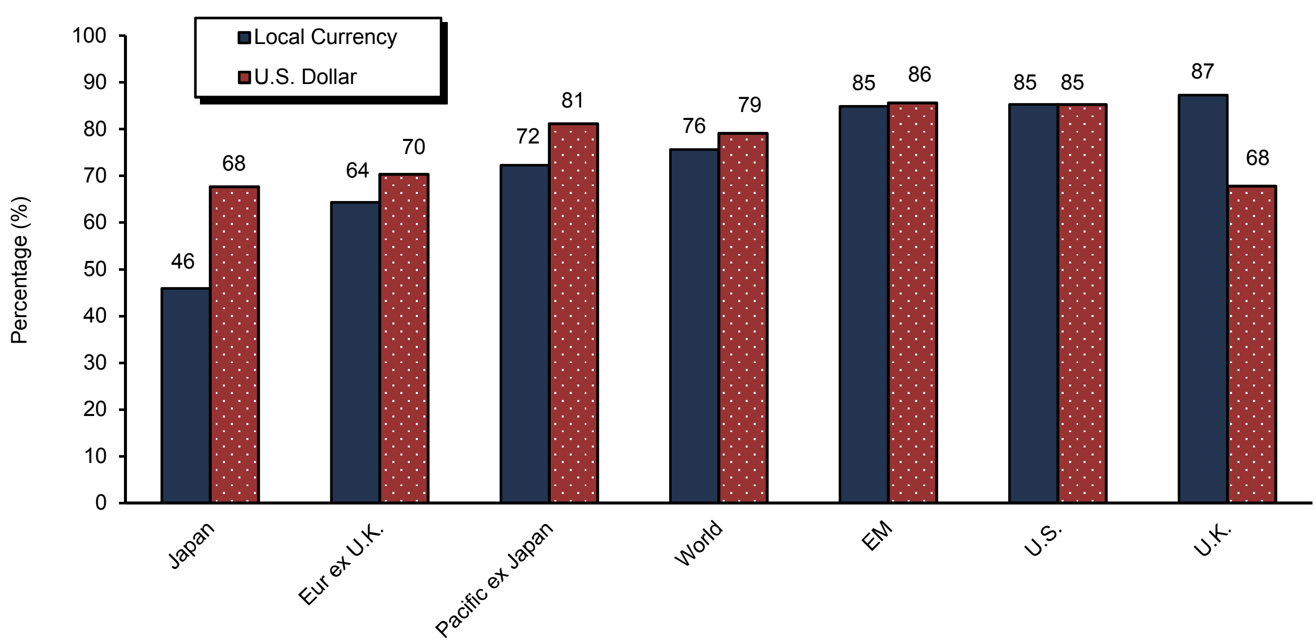

Sources: Barclays Capital, Bloomberg L.P., BofA Merrill Lynch, Citigroup Global Markets, Dow Jones & Company, Inc., FTSE International Limited, J.P. Morgan Securities, Inc., Merrill Lynch & Co., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Datastream. 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. Fiscal year begins July 1 and ends June 30.

**Exhibit 3**

## Global Market Rallies and Subsequent Declines

January 1, 2007 – June 30, 2011



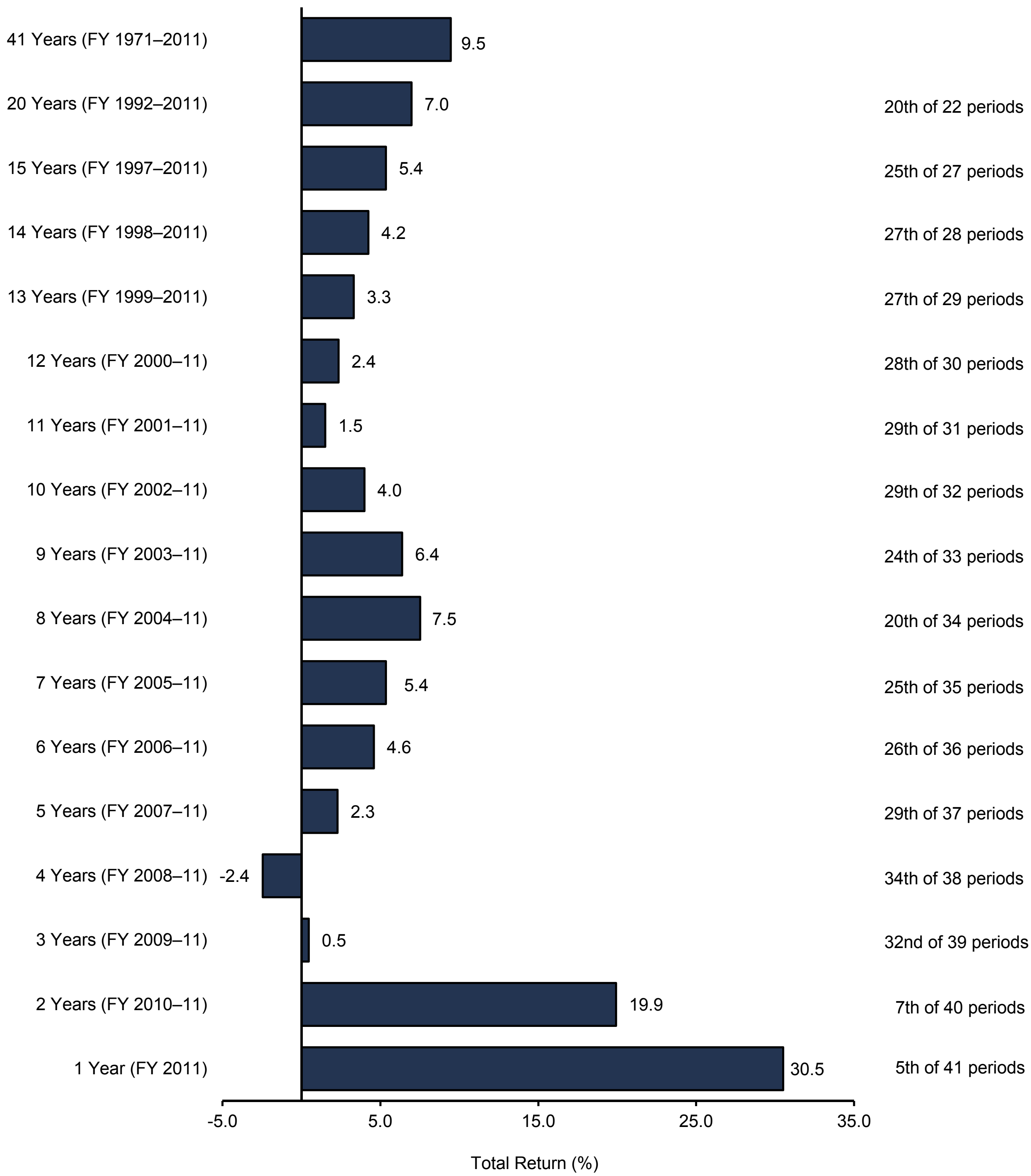




Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Peak and trough dates are based on each individual region's peak and trough. The bottom graph shows the percentage of the 2007 peak level that has been recovered to date. For example, a 50% decline would require a 100% rally to return to peak level.

**Exhibit 4**

## MSCI World Average Annual Compound Returns for Various Time Periods

Periods Ended June 30, 2011 • U.S. Dollar

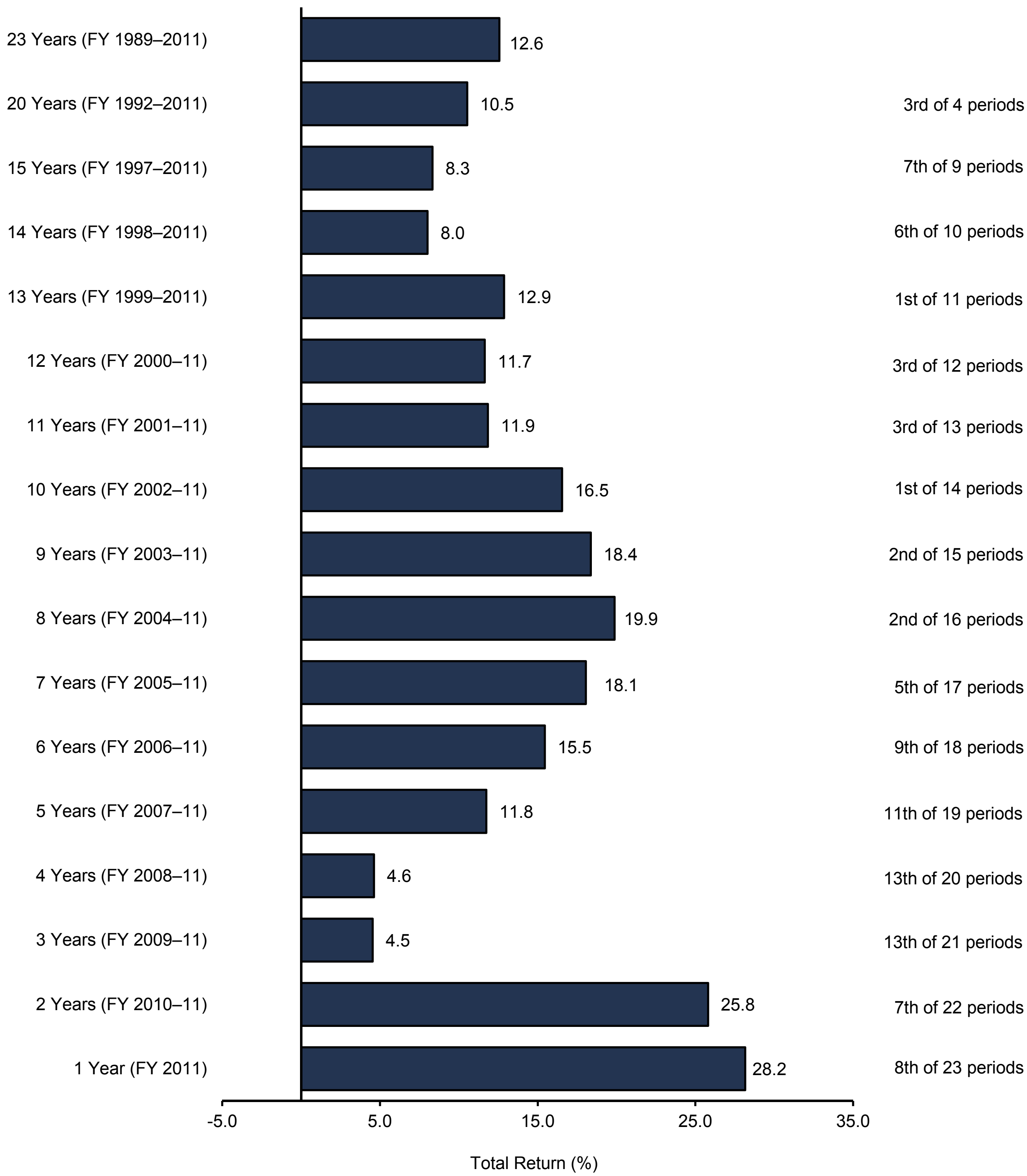



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: A ranking of first indicates the best performance among all periods. Total returns for the MSCI World Index are net of dividend taxes.

**Exhibit 5**

## MSCI Emerging Markets Average Annual Compound Returns for Various Time Periods

Periods Ended June 30, 2011 • U.S. Dollar

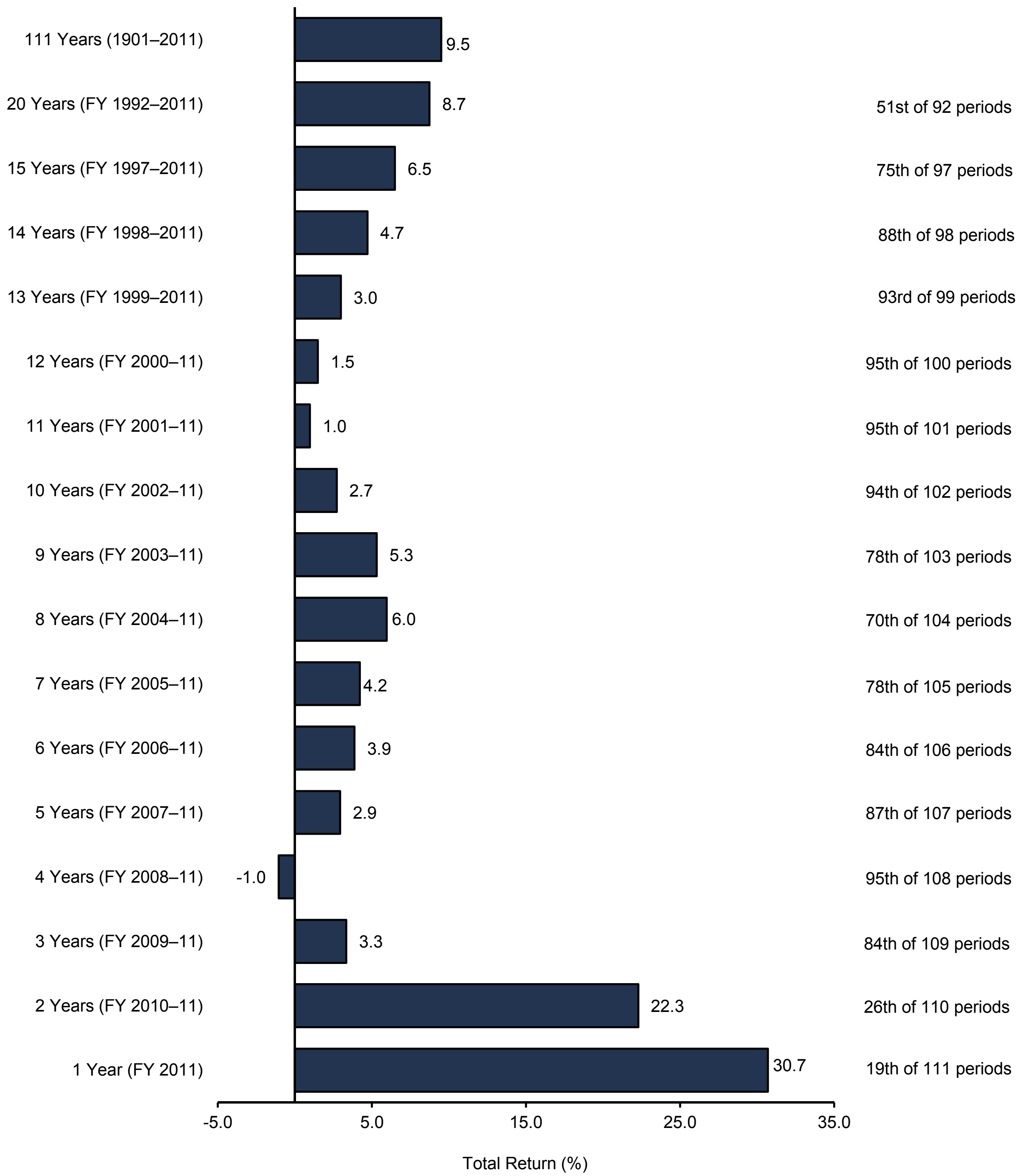



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: A ranking of first indicates the best performance among all periods. Total returns for the MSCI Emerging Markets Index are gross of dividend taxes.

**Exhibit 6**

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

Periods Ended June 30, 2011 • U.S. Dollar

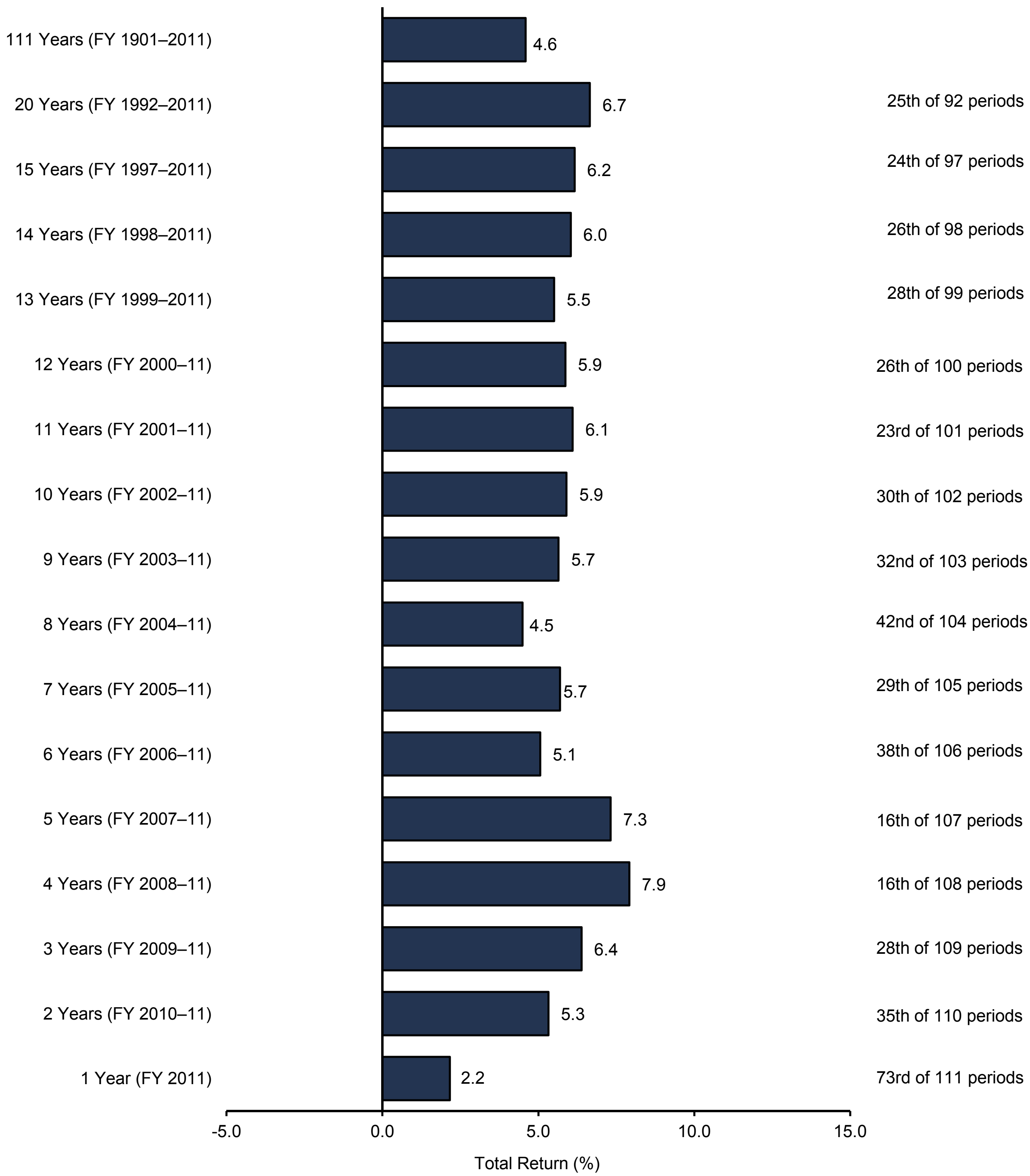



Sources: Global Financial Data, Inc., Standard & Poor's, and Thomson Datastream.
Note: A ranking of first indicates the best performance among all periods.

**Exhibit 7**

## Ten-Year Treasury Average Annual Compound Returns for Various Time Periods

Periods Ended June 30, 2011 • U.S. Dollar

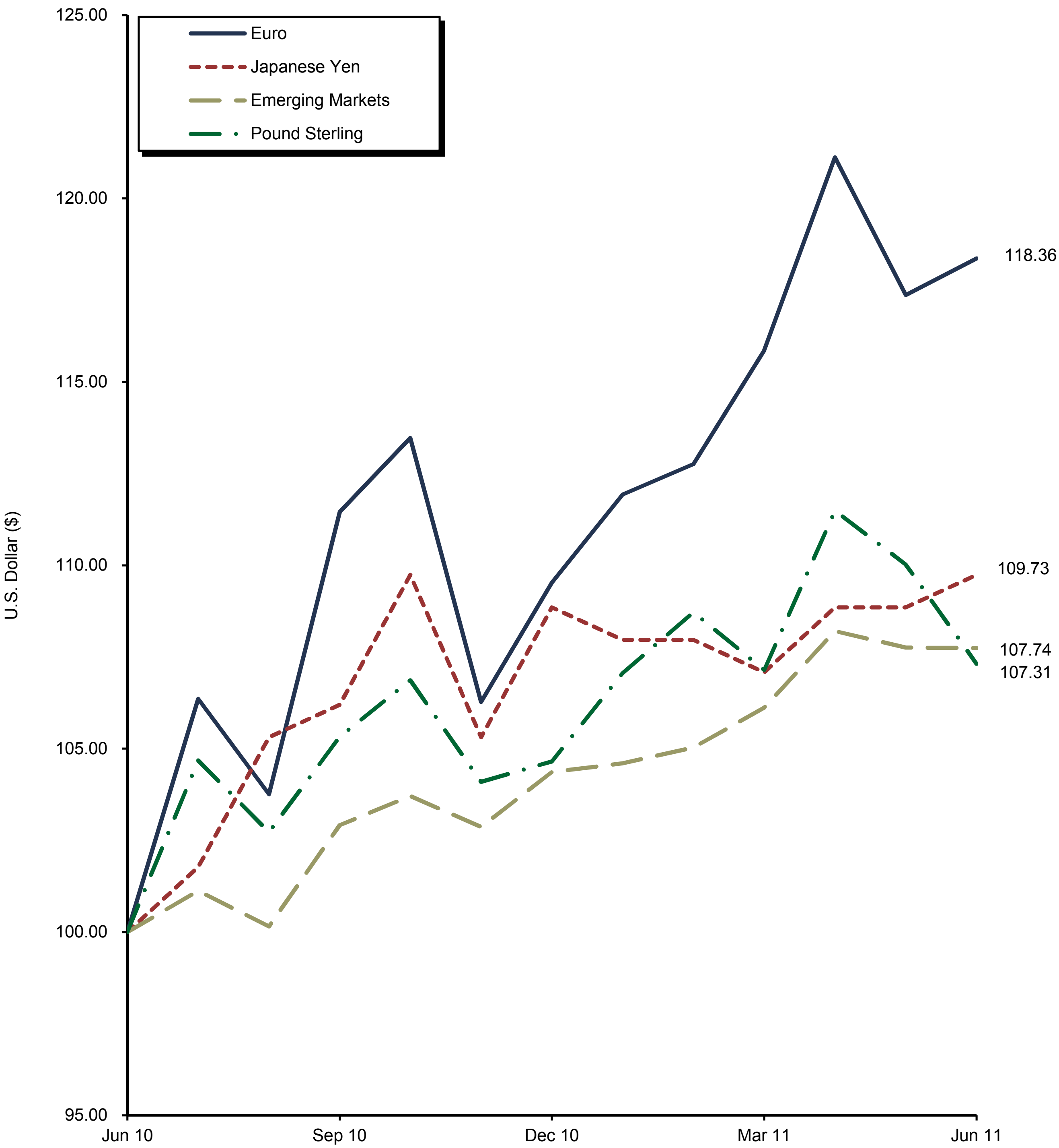



Sources: Global Financial Data, Inc. and Thomson Datastream.
Note: A ranking of first indicates the best performance among all periods.

**Exhibit 8**

## Cumulative Wealth of $100 in Various Currencies

Fiscal Year 2011 • U.S. Dollar

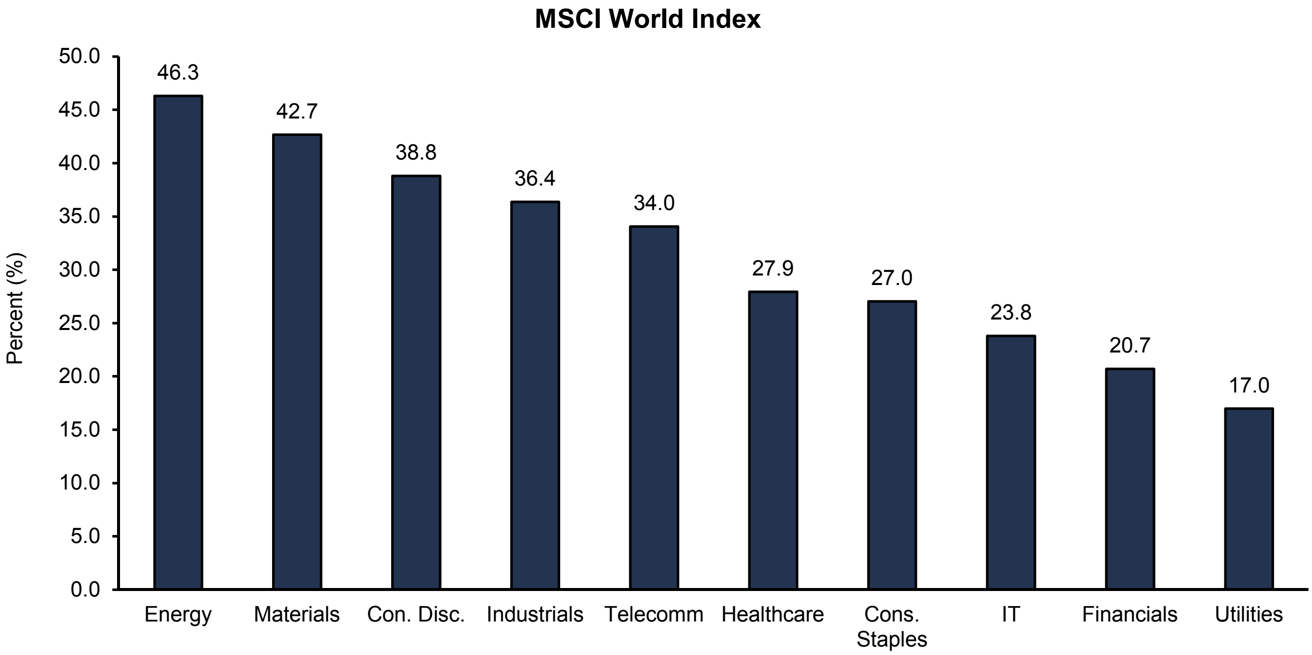


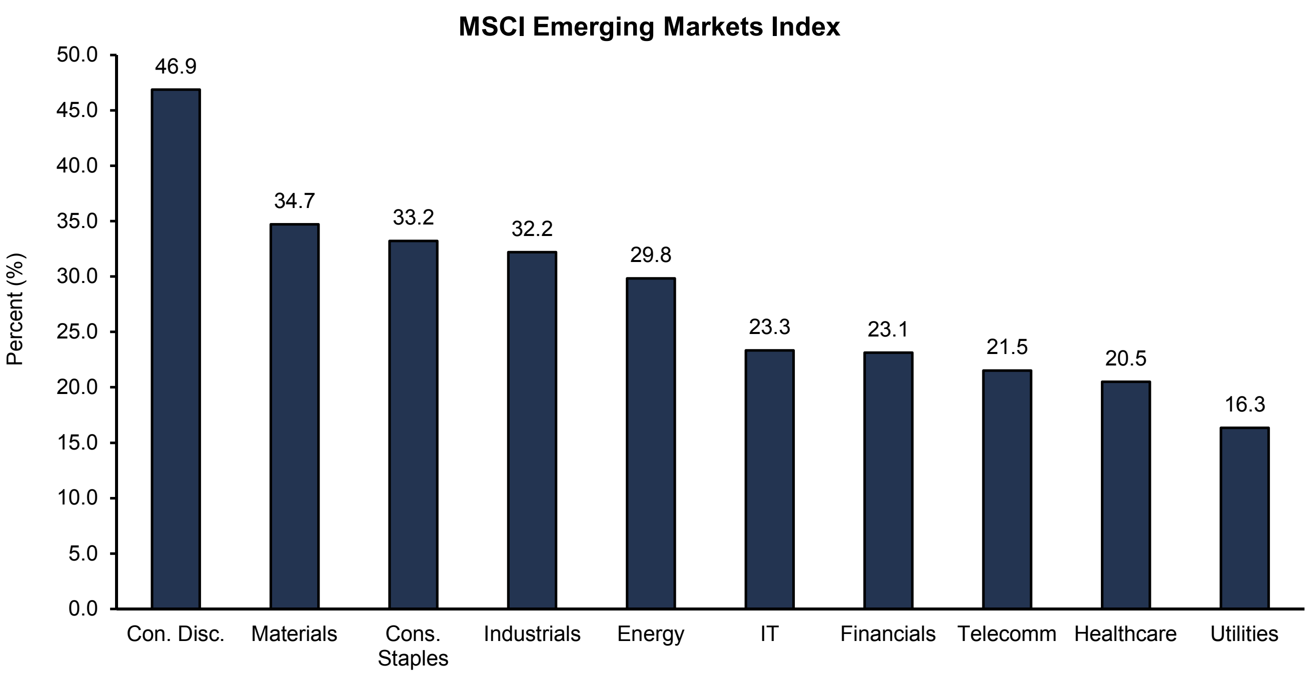

Source: Thomson Datastream.
Notes: All currencies are versus the U.S. dollar. The emerging markets currency is a trade-weighted basket of emerging markets currencies. Fiscal year begins July 1 and ends June 30.

**Exhibit 9**

## Global Equity Sector Performance

Fiscal Year 2011 • U.S. Dollar



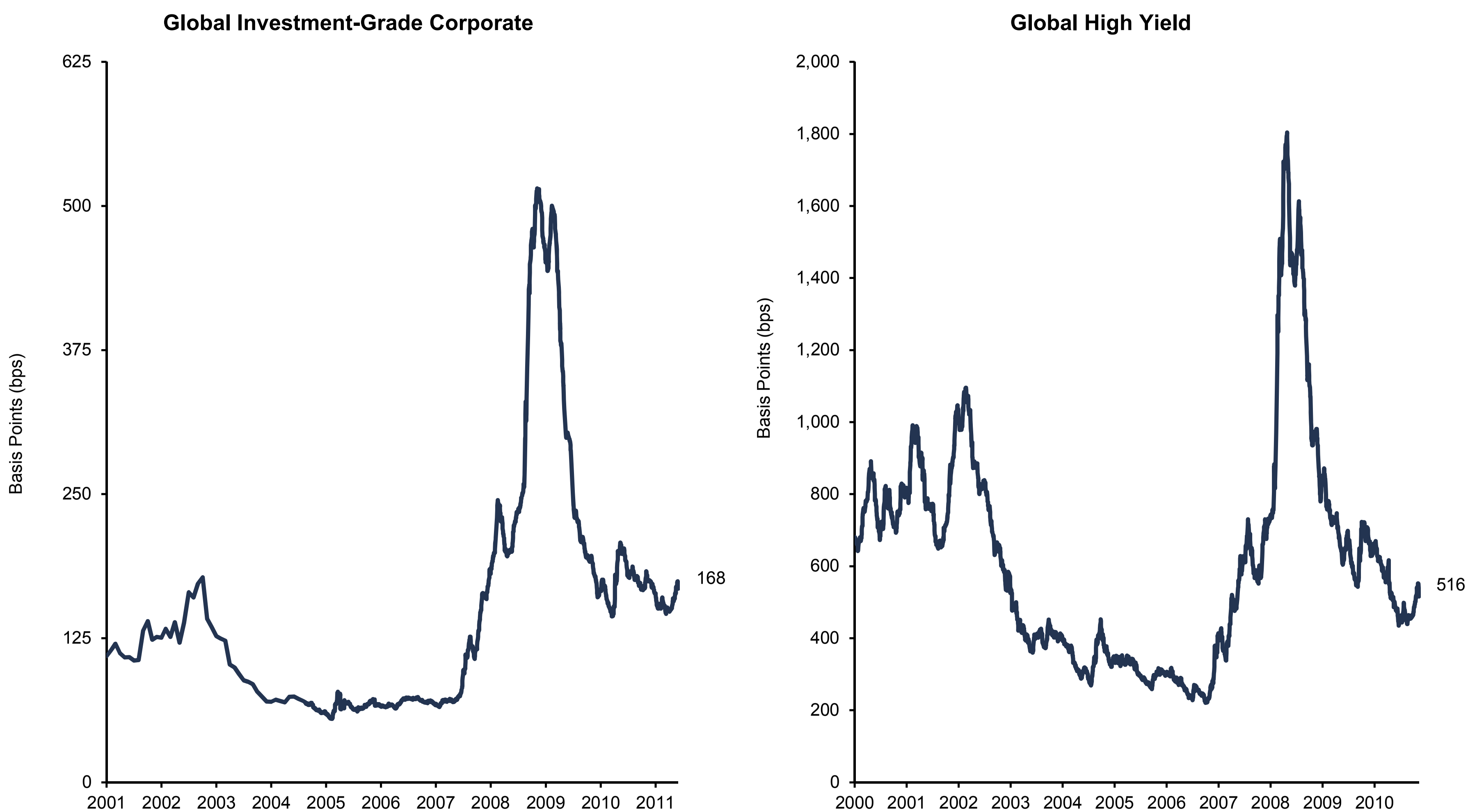




Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI developed markets are net of dividend taxes. Total returns for MSCI emerging markets are gross of dividend taxes. Charts are sorted by 2011 fiscal year sector performance. Fiscal year begins July 1 and ends June 30.

**Exhibit 10**

## Option-Adjusted Spreads on Global Corporates and High Yield

August 23, 2000 – June 30, 2011

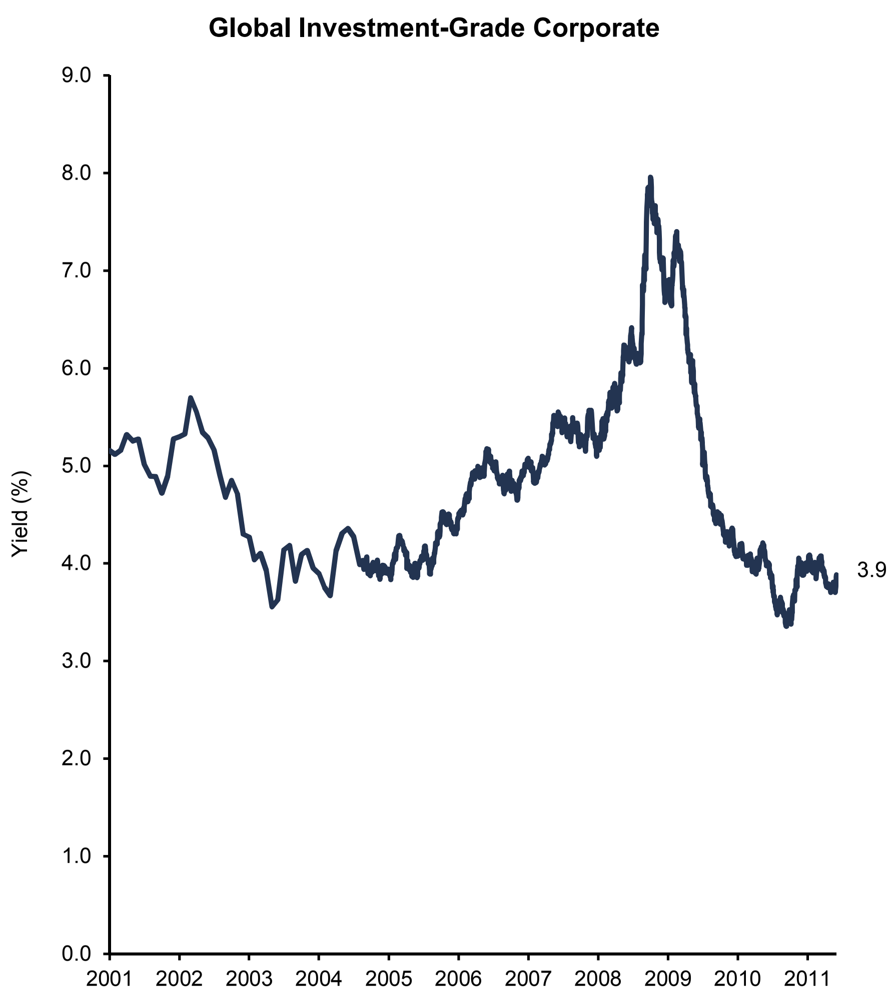


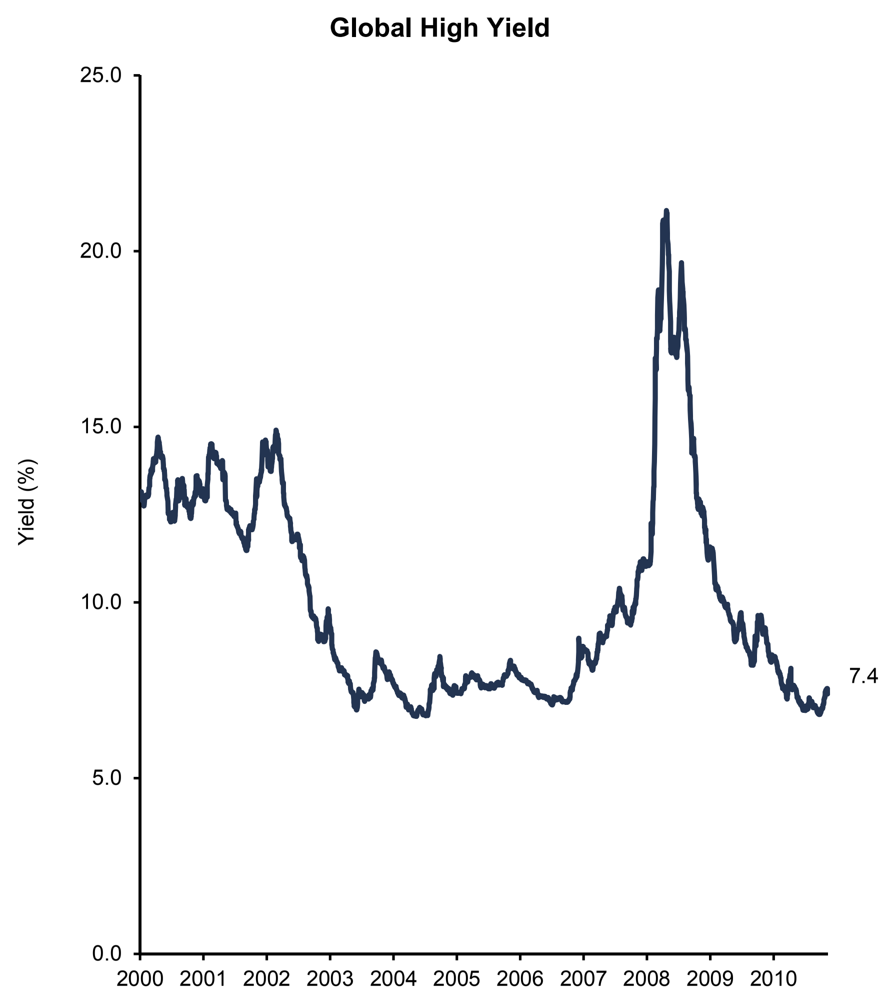

Source: Barclays Capital.
Notes: Monthly data for investment-grade corporates start January 2001. Daily data for investment-grade corporates begin September 14, 2004.

**Exhibit 11**

## Yields on Global Corporates and High Yield

August 23, 2000 – June 30, 2011



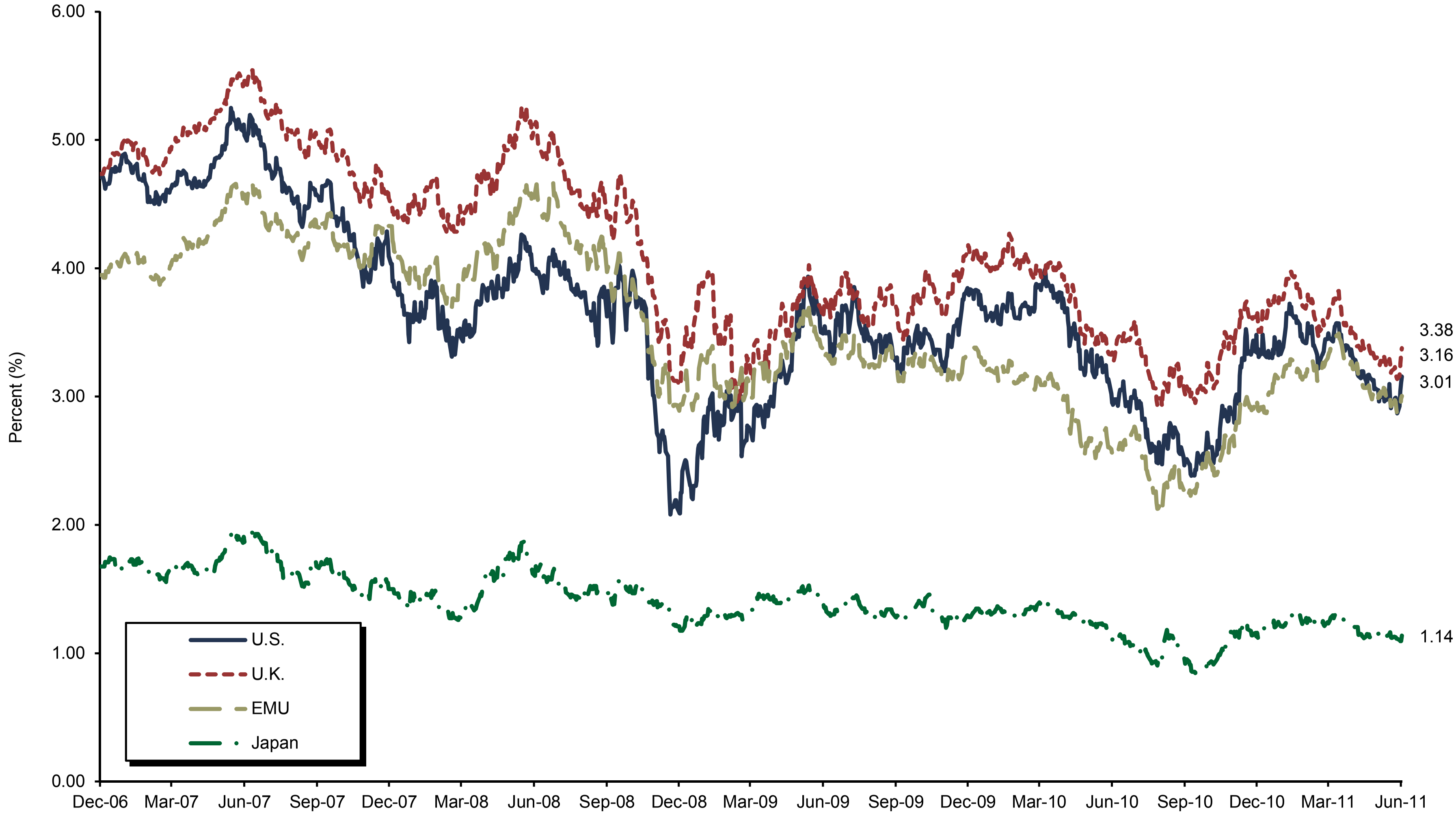




Source: Barclays Capital.
Notes: Monthly data for investment-grade corporates start January 2001. Daily data for investment-grade corporates begin September 14, 2004.

**Exhibit 12**

## Ten-Year Government Bond Yields

December 31, 2006 – June 30, 2011




Source: Thomson Datastream.
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