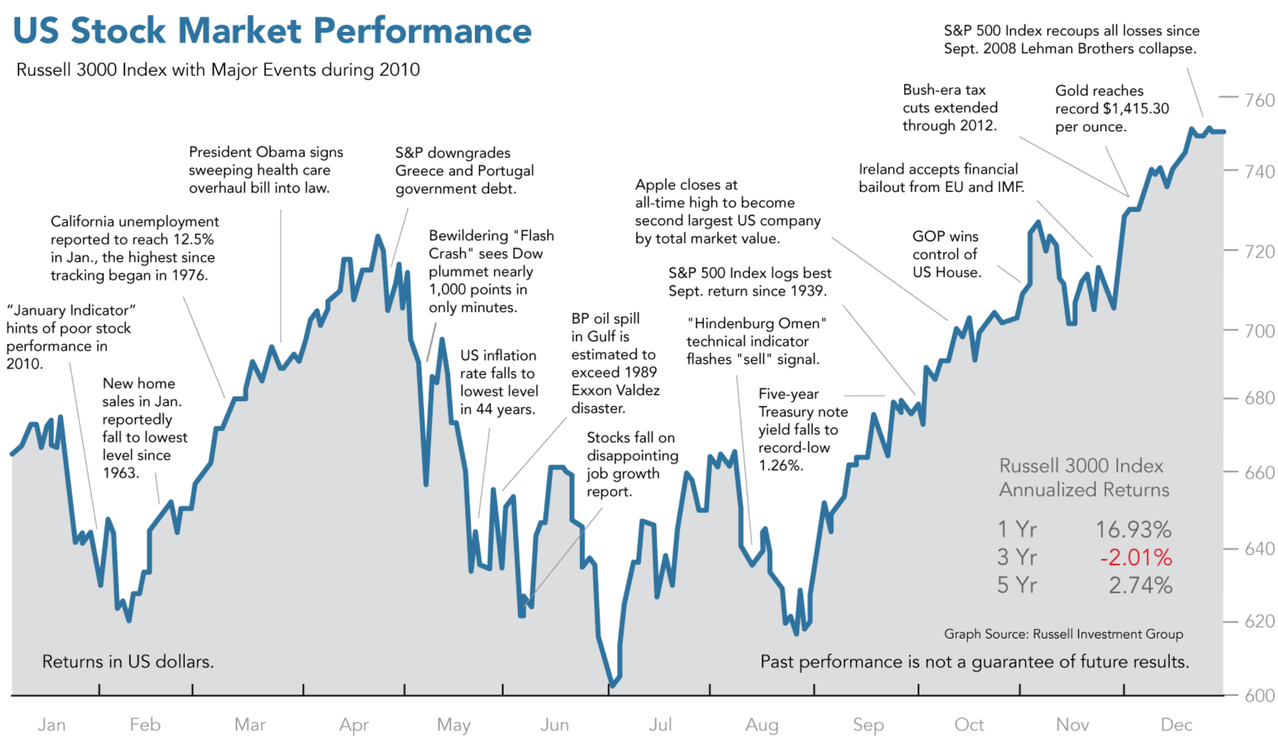
2010 Review: Economy & Markets

The past year offered an interesting mix of positive and negative news as investors around the world eagerly anticipated signs of economic recovery and financial stabilization. While most financial markets logged positive returns for a second straight year, investors had to endure a host of troubling news and pessimistic market predictions. Even eight months into the year, the S&P 500 Index was down 5.9%. But diversified, long-term investors were rewarded with attractive market returns, as the S&P 500 closed the year up 15.06%, with 10.76% of the gain coming in the fourth quarter. (Returns are in US dollars throughout this report.)

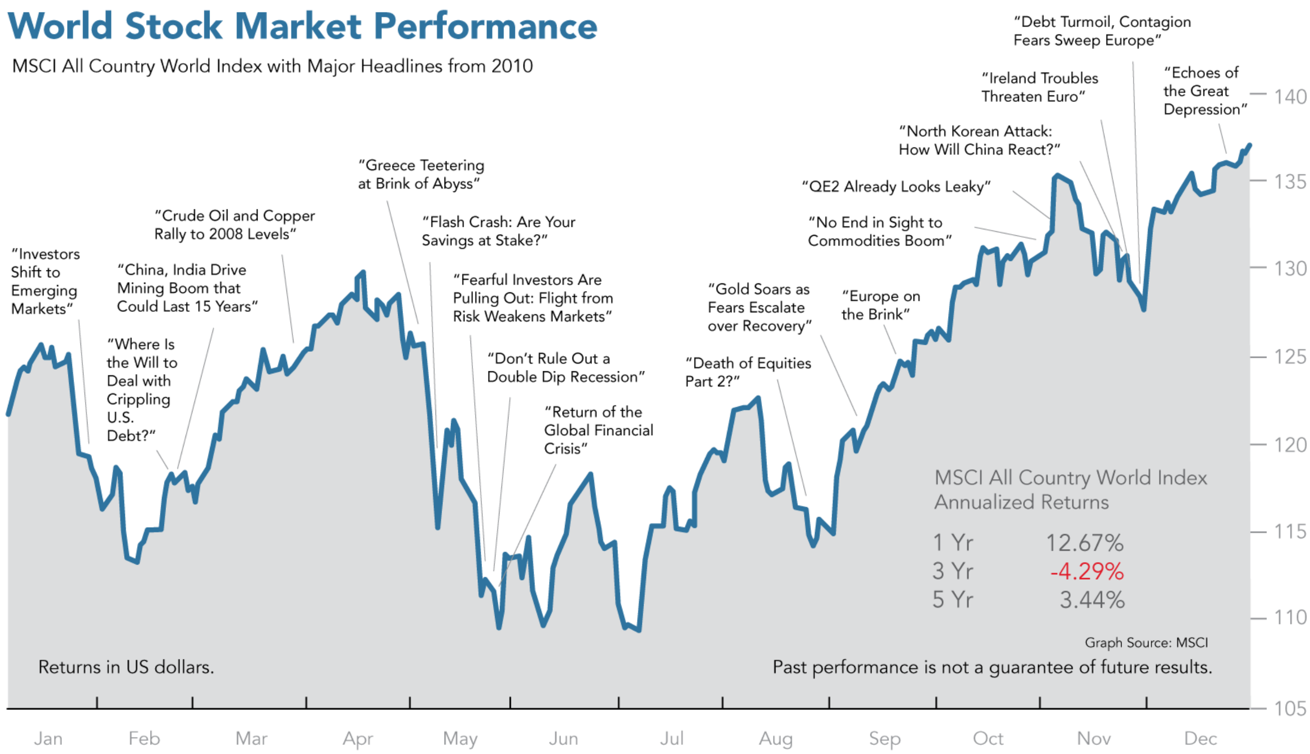
Stocks performed well in the US and most developed countries, and across size and value risk factors, despite ongoing concerns over a possible double-dip recession, rising government indebtedness, and inflation. Thirty-seven out of forty-five countries tracked by MSCI achieved positive returns in both local currency and US dollar terms.

Fixed income returns were positive, thwarting assertions that bond prices were in dangerous “bubble” territory. Despite continued weakness in residential housing and commercial property, real estate securities around the world outperformed the broad equity market. Diversification across the size and value risk dimensions proved rewarding in both US and non-US markets, particularly among small company stocks.



As shown in the US Stock Market Performance chart, the broad US stock market logged strong performance, returning 16.93% for the calendar year. The chart features some of the year’s most highly publicized events. These events are not offered as an explanation of market performance, but simply to illustrate that long-term investors faced a major challenge to stay disciplined in a volatile news environment. Although investors must deal with uncertainty in all markets, 2010 may have presented a more intense challenge as markets watched for signs of economic recovery from the global financial crisis.

The World Stock Market Performance chart offers a snapshot of global stock market performance, as measured by the MSCI All Country World Index. Actual headlines from publications around the world are featured. Again, these headlines are just a sample of many events during the year.



Throughout the year, investors could find a host of reasons to avoid stocks and wait for more positive news before returning to the market. As these select headlines suggest, determining the right time to invest is a difficult task since the market anticipates news and quickly factors in new information.

The Year in Review

Themes in 2010

In retrospect, it was a good year for globally diversified investors. But if investors had shaped their market expectations and decisions according to economic news, they likely would not have expected positive returns. The following are a few dominant themes during the year.

Mixed Economic Signals

Although investors in the US and Europe awaited signs of a rebound, economic news was mixed, with some measures showing gradual improvement and others offering evidence that the economy remains vulnerable. Favorable news included moderate economic expansion in the US, Euro zone, and Australia, as well as rising factory orders and manufacturing activity, rebounding auto sales and automaker profits, slowing growth in US bankruptcies, declining home foreclosures, and an improving financial services sector. In late Q3, US corporate cash levels reached $1.9 trillion, which, as a percentage of total corporate assets, is the highest since 1959. In late Q4, initial claims for unemployment fell to the lowest level in two years.

Negative news included continuing high jobless rates in the US and other developed markets. US unemployment began the year at 9.7%, dipped to 9.5% in July, but climbed to 9.8% in November. Personal bankruptcies in the US increased 9%, reaching their highest level since 2005. Also, bank failures in 2010 were the worst since 1992, during the savings and loan crisis.

Housing and Real Estate
The global property decline that helped trigger the 2008 financial crisis began to ease in 2010. Home prices improved in the UK but remained weak in the US, with monthly sales of new homes falling at one point to the lowest level since tracking was initiated in 1963. Foreclosures increased dramatically in the first half of 2010 before improving in Q4. However, 2010 proved to be another successful year for REITs, despite recurring predictions of a brewing commercial real estate collapse that would trigger a financial crisis.

Quantitative Easing and Fiscal Stimulus
Governments and central banks took additional actions to stimulate economies and shore up financial markets. The most direct support came as central banks supported government bond markets in the US and Europe. The Federal Reserve's November announcement of a second round of quantitative easing (known as "QE2") sparked concern that additional monetary stimulus would stoke inflation and debase the dollar. According to some, the actions helped lift stocks and corporate bond markets. In December, the extension of the Bush-era tax cuts and a 2% reduction in Social Security payroll taxes in 2011 improved economic expectations.

Sovereign Debt Worries
During the year, the weakening finances of some European states, including Portugal, Ireland, Italy, Greece, Spain, and Belgium, raised concern that the financial crisis had moved from private-sector banks to public-sector balance sheets. These concerns led to the downgrading of certain government debt and widening of bond yield spreads. The Euro zone countries and International Monetary Fund responded with loans that were conditional on some sovereign borrowers taking drastic austerity measures.

Inflation vs. Deflation
Despite moderate inflation in most economies during 2010, economists warned that continued government budget deficits and monetary expansion would drive up prices. Conversely, the US central bank was concerned that inflation was so low that the economy might slip into a deflationary cycle. In fact, potential deflation was one of the main reasons the Fed implemented QE2 and pumped $600 billion into the banking system. By year end, the Fed indicated that the deflation threat was easing.

Higher Commodity Prices
Commodities climbed during 2010, with many sectors reaching price levels not seen in decades. Copper prices, which are considered a bellwether of economic activity, rose 33%, and oil gained 15% to finish 2010 over $91 a barrel. Agricultural commodities, a traditionally volatile sector, saw even more extreme price swings. Concern about a weakening dollar drove up precious metals, with gold exceeding $1,400 per ounce and silver up 81% for the year.

Investor Confidence
In the wake of the financial crisis, investors who have become more risk averse or accepted the tenets of a "new normal" in the economy and markets chose to remain in fixed income assets. Bond funds in the US received a

massive net inflow of money in the past two years, suggesting that many investors who fled stocks may have missed out on much of the rebound in equities. Throughout most of 2010, investment flows were leaving the US stock market and moving to emerging markets. In December, flows turned sharply positive in the US, with an estimated $22 billion directed to US stock funds.

2010 Investment Overview

After a slow start and a tough second quarter, most markets in the world ended the year with positive results. The US market indices accounted for most of the top performance, with the Russell 2000 Growth Index delivering a 29.09% return for the year. US small cap and small value also were among the top performers. (All returns are in US dollars.)

Most developed markets around the world logged positive returns, with thirty-seven of the forty-five countries that MSCI tracks gaining ground in both local currency and US dollar terms. Scandinavia and Asia had particularly high returns. Overall, the MSCI World ex USA index gained 9%, and the MSCI Emerging Markets Index gained 19% for the year.

In the last few months of the year, the highest returns were generally experienced by countries whose economies are dominated by oil and commodity exports—for example, Canada, Norway, Russia, and South Africa. Other emerging markets, such as Thailand, Philippines, Chile, and Peru had strong returns. China, despite its continued high profile and news of economic growth, was one of the lowest-performing emerging markets.

The US dollar lost ground against the Canadian dollar and most Pacific Rim currencies, which helped dollar-denominated equity returns from those countries. The US dollar gained against the euro and British pound.

Along the market capitalization dimension, small caps outperformed large caps by substantial margins in the US, developed, and emerging markets. Value stocks underperformed growth stocks across all market capitalization segments in the US and had more mixed results in international developed and emerging markets.

Fixed income performed generally well, especially for investors who took term and credit risk, with long-term, high-yield bonds

Major World Indices

US Equity Returns

As of December 31, 2010	Return (%)		
Index	Fourth Quarter	One Year	Three Years*
Russell 3000	11.59	16.93	(2.01)
Russell 2500	14.86	26.71	2.49
Russell 2000	16.25	26.85	2.22
Russell 2000 Value	15.36	24.50	2.19
Russell 2000 Growth	17.11	29.09	2.18
Russell 1000	11.19	16.10	(2.37)
Russell 1000 Value	10.54	15.51	(4.42)
Russell 1000 Growth	11.83	16.71	(0.47)
S&P 500	10.76	15.06	(2.85)

Non-US Equity Returns

As of December 31, 2010	Return (%)		
Index	Fourth Quarter	One Year	Three Years*
MSCI EAFE Small Cap	11.80	22.04	(1.72)
MSCI World ex USA Small	12.86	24.51	(0.81)
MSCI EAFE	6.61	7.75	(7.02)
MSCI World ex USA	7.16	8.95	(6.33)
MSCI EAFE Value	5.30	3.25	(8.15)
MSCI EAFE Growth	7.85	12.25	(5.94)
MSCI Emerging Markets	7.34	18.88	(0.32)
MSCI Emerging Markets Small	7.92	27.17	4.33

Fixed Income Returns

As of December 31, 2010	Return (%)		
	Fourth Quarter	One Year	Three Years*
BofA Merrill Lynch Three-Month US T-Bill	0.04	0.13	0.79
BofA Merrill Lynch One-Year US Treasury Note	0.07	0.83	2.11
Citigroup World Government Bond 1-3 Years (hedged)	(0.10)	1.35	2.97
Barclays Capital US Government Bond	(2.34)	5.52	5.07
BofA Merrill Lynch 1-5 Year US Treasury and Agency	(0.59)	3.46	4.20
Citigroup World Government Bond 1-5 Years (hedged)	(0.50)	1.99	3.60
Barclays Capital US TIPS	(0.65)	6.31	4.97

Real Estate Returns

As of December 31, 2010	Return (%)		
	Fourth Quarter	One Year	Three Years
Dow Jones US Select REIT	7.45	28.07	1.01
S&P Global ex US REIT	6.39	16.91	(8.04)

*Annualized

Past performance is not a guarantee of future results.
Returns in US dollars.

returning more than 20%. Real estate securities had excellent returns, performing comparably to the equity asset classes.

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Returns in US dollars.

Quarterly Highlights

First Quarter

Following a slow start in the year, equity markets around the world began to climb in mid-February and ended the first quarter in the black. The broad US market gained about 6% in the quarter, with all asset classes delivering solid gains. (All returns are in US dollars.) The developed markets benchmark MSCI World ex US Index was up 6.4% in March and finished the quarter with a return of 1.3%. Emerging markets outperformed the developed markets, up 8.1% in March and 2.4% for the quarter. Some of the larger markets, such as Brazil, China, and Taiwan, had negative returns. As in the case of developed markets, there was much dispersion in the performance of different emerging markets and asset classes. However, both developed and emerging underperformed the US, partially due to the stronger US dollar, which was up 6% against the pound and the euro, hurting the dollar-denominated returns of developed market equities. Fixed income securities had positive returns. Longer-term securities tended to have better performance than short-term ones.

Major news in the developed markets was related to the fiscal crisis in Greece and the resulting worry about the mechanics of a bailout and its impact on the euro. As a result, the worst equity market returns were in Europe, where stocks slipped in Greece, Portugal, and Spain—the countries most at risk of sovereign default.

Second Quarter

After four consecutive quarters of strong performance, the US equity market saw a sharp reversal in May and June, ending the second quarter with large negative returns. The broad US market lost over 11%, with most asset classes delivering double-digit negative returns. Both developed and emerging markets performed poorly. The MSCI World ex US Index was down 13.6% for the quarter, with most of the damage coming in May, when the index fell 11%. Emerging markets outperformed developed markets for the second quarter in a row, down 8.4%. The US dollar gained ground against most major currencies, especially the euro and the Australian dollar, and against major emerging market currencies. This strong performance hurt dollar-denominated returns of developed and emerging market equities. Fixed income securities had good returns due to a flight to safety triggered by the sovereign debt problems in Europe and weak economic data around the globe. Intermediate government securities and inflation-protected securities did particularly well.

The sovereign debt crisis in Greece, Spain, Portugal, and Ireland continued to affect European banks. Officials in Hungary hinted at a default, and Spain's credit was downgraded. Widespread announcements of austerity measures and budget cuts across Europe caused some observers to lower growth expectations. Other major events were the April explosion of the Deepwater Horizon rig in the Gulf of Mexico, which cast a negative spotlight on BP and raised concerns of a major environmental calamity, and the bewildering "flash crash" in May, which saw the Dow plummet over 1,000 points in the course of a few frantic minutes.

Third Quarter

The US equity market rallied strongly in the third quarter, with the broad US market gaining over 11% and most asset classes delivering double-digit returns. With the exception of Q2 and Q3 of 2009, non-US markets had their best quarter since 2003. Although both developed and emerging markets did well, emerging markets once again had the strongest performance. Looking at benchmark returns, strong performance in July and September led the MSCI Emerging Markets benchmark to a quarterly return of 18%. By comparison, the benchmark MSCI World ex US Index was up 16%.

The US dollar lost ground against most major currencies in developed and emerging market countries, which greatly helped the dollar-denominated equity returns. Fixed income securities had good returns. Declining long-term rates rewarded investors who were exposed to term risk. Intermediate government securities and inflation-protected securities did particularly well.

International news focused on central banks around the world intervening to curtail rising currencies, with the focus on Japan and China.

Fourth Quarter

The equity markets had a strong finish for the year, with the broad US market gaining over 11%. US asset classes again delivered double-digit returns. Most of the world's stock markets continued with the gains experienced in the third quarter, albeit at more moderate pace. The MSCI World ex US Index and the MSCI Emerging Markets Index both had returns of over 7%. Returns were especially good in Canada and Japan, which returned over 12%. Emerging markets had slightly higher performance than developed markets. The US dollar lost ground against the Canadian dollar and most Pacific Rim currencies, which greatly helped the dollar-denominated equity returns from those countries. However, the US dollar gained against the euro and British pound.

Value stocks underperformed growth stocks across all market capitalization segments in the US and in other developed markets. In emerging markets, value stocks outperformed growth stocks for the quarter. Small cap value stocks outperformed small cap growth stocks, while large cap value stocks underperformed large cap growth stocks. Along the market capitalization dimension, small caps outperformed large caps in the US and developed markets by substantial margins. In emerging markets, small caps narrowly beat large caps.

Fixed income securities had generally poor returns in the fourth quarter. Rising long-term rates hurt investors who were exposed to term risk. However, high-yield bonds did particularly well, rewarding investors who took extensive credit risk. Notwithstanding the continued weakness in the commercial and residential real estate markets, real estate securities had excellent returns, performing comparably to the equity asset classes.

Notable events included the mid-term election results in the US, which resulted in an anticipated shift in the political landscape. There was additional anxiety over sovereign debt, with the Irish system accepting an €85 billion bailout from the Euro zone. Finally, the implementation of quantitative easing (QE2) by the US central bank contributed to a weakening dollar across most major world currencies, with the exception of the euro, which continued to struggle.