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## Asset Class Summaries

### First Quarter 2010

#### TIPS

Real yields were mixed during the quarter with securities out to seven years declining in yield, while longer maturity real yields increased 10-15 basis points. Breakeven inflation rates followed the same pattern as short-maturity TIPS outperformed nominal Treasuries, while long maturity TIPS lagged. TIPS 10-year breakeven decreased to 2.26%. Weaker core inflation was the main driver for lower long-term inflation expectations. Meanwhile, short-maturity breakevens were lifted by higher oil prices, which quickly translated into higher gasoline prices and headline CPI.

#### Munis

Muni yields fell for much of the quarter as demand continued to overwhelm supply. Yields rose on short- and intermediate-maturities, while yields on long-maturities remained stable, reflecting the lack of new issuance for long-maturity tax-exempt bonds as supply was diverted into the taxable Build America Bonds (BABs). This shift in issuance will likely continue as legislation is in the works to expand the program and extend it out to 2013, though with the possibility of a reduced rate of subsidy. Lower-rated securities continued to see price strength as investors were attracted to their higher yields, outperforming higher-rated issues. Moody's and Fitch announced they would begin their long-delayed "recalibration" upward of municipal ratings to their respective global ratings scales beginning in April. This is intended to standardize comparisons of credit risk scores across all fixed income sectors, not just within municipals. The sectors most likely affected are GO bonds and public higher education and public power distribution. It's important to note these shifts should not be viewed as ratings upgrades. Municipal finances remain problematic as states proactively seek to balance significant budget gaps before fiscal year-end. California's fundamental credit problems were largely ignored in the wake of a successfully completed \$3.4 billion taxable bond issue, of which was 30% of the buyers were foreign investors.

#### Foreign Bonds

Global sovereign rates were mixed as markets across the regions were at different stages of monetary and fiscal policy. The Greek sovereign debt crisis weighed on European bonds as investors priced in rising credit risk and slower economic prospects. Japan continued to fight strong deflationary pressures and announced incremental easing measures. Australia was the first major central bank to increase rates, reflecting evidence they largely avoided the difficulties experienced in other major developed countries. The euro declined across the board due to damaged confidence and the prospect of fiscal tightening and continued low rates. The U.S. dollar rose against most major currencies on improving economic and rate prospects. As sovereign debt worries plagued developed countries, fast growing emerging market bonds drew renewed attention from investors. EM currencies performed well on higher oil prices and strong Asian growth. In many cases, emerging market's balance sheets are stronger than their developed siblings. Further driving the strong performance of the emerging debt markets was continued inflows, which helped the market absorb new issuance and tighten spreads on existing bonds.

#### High Yield

High yield bonds posted solid gains during the quarter. Credit spreads have tightened substantially off their December 2008 highs, supported by rising corporate profitability and demand among investors seeking higher-yielding assets. Corporate fundamentals continued to strengthen as most credits witnessed quarter-over-quarter revenue and earnings growth. Financials continued to lead the charge as the capital markets embraced the notion that an implied "safety net" has been extended around all systemically critical financial institutions, and even those which are less systemically critical. Record new supply was met eagerly by strong demand as improving economic conditions and declining defaults encouraged inflows. Much of the new supply has been used to fund acquisitions rather than repairing balance sheets. On a par basis, the 12-month default rate declined to 6.3% versus 10.3% at year-end, while rating upgrades outpaced downgrades by a two-to-one margin. In a continuation from 2009, lowest-rated credits fared best.

#### Fixed Income

Accommodative monetary policy and improved economic fundamentals eased investor worries over long-term structural issues including over-leveraged commercial and residential real estate and sovereign and municipal fiscal imbalances. Treasuries advanced 1% for the quarter though sold off late in March triggered by a number of poorly executed auctions which called into question the ability of the U.S. Treasury to attract buyers. The successful passage of healthcare reform raised the specter of further long-term pressure on federal finances from entitlement programs. 10-year Treasury yields were virtually unchanged. However, investor caution manifested itself into a steeper yield curve as the 2-year to 30-year spread widened from 3.5% to 3.7%. TIPS 10-year breakeven decreased to 2.26% on lower inflation expectations. Corporate bonds, especially high yield, posted solid gains during the quarter. Credit spreads have tightened substantially off their December 2008 highs, supported by rising corporate profitability and demand among investors seeking higher-yielding assets. The agency MBS market was driven by continued Fed participation, as the long awaited completion of its purchase program ended on March 31<sup>st</sup>. Continued absence of new supply and investor's hearty appetite for yield drove non-agency MBS gains. CMBS posted strong gains as investors sought higher yielding assets on the belief the worst credit outcome has passed. Consumer ABS performance has improved with better macroeconomic conditions, particularly for auto and credit card.

#### Balanced

Stocks rallied in the first quarter, extending their winning streak to four consecutive quarters. Signs of continued economic expansion and subdued inflation lifted shares of industrial, finance, and consumer related names. Turmoil in the U.S. political



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landscape and budget issues in Europe upset the markets mid-quarter. However, above consensus earnings and the return of individual investors helped the markets regain their footing and stage a late-quarter rally. Fixed income posted gains during the quarter. Accommodative monetary policy and improved economic fundamentals eased investor worries over long-term structural issues including over-leveraged commercial and residential real estate and sovereign and municipal fiscal imbalances. Credit sectors led this quarter. The lower rated bonds outperformed as risk appetite continued to strengthen and investors looked for additional yield pickups.

#### Broad Equity

U.S. equity markets opened with a strong first quarter amid signs of a strengthening global economy, rising corporate profitability and a stabilizing financial system. Meanwhile, inflation levels remained subdued. The avoidance of a Greek sovereign debt default seemed to outweigh lingering concerns about high unemployment levels, credit tightening in China and weak economic data from Europe. The recent agreement between Eurozone members and the IMF to jointly bailout Greece appears to have alleviated some investor anxiety, at least temporarily. The S&P 500 Index and the Russell 2000 Index of smaller companies advanced 5% and 9%, respectively. Industrials, financials and consumer discretionary were among the top performing sectors, while telecommunications services, utilities and energy underperformed. Across market capitalizations, small- and mid-cap issues outperformed larger companies. Value stocks outperformed growth stocks across all market capitalizations.

#### Large Value

Value stocks rallied in the first quarter, extending their winning streak to four consecutive quarters. Signs of continued economic expansion and subdued inflation lifted shares of industrial, finance, and consumer related names. Turmoil in the U.S. political landscape and budget issues in Europe upset the markets mid-quarter. However, above consensus earnings and the return of individual investors helped the markets regain their footing and stage a late-quarter rally. Financials led the way, rebounding despite competing bank reform proposals by the White House and the House Financial Services Committee. Banks continued to work through non-performing assets and show profits, benefiting from a steep yield curve. The resurgent capital markets bode well for increased M&A and new issue business for diversified financial companies. Consumer discretionary and industrials posted solid gains as consumer spending improved and manufacturing expanded. Despite attractive yields, investors had little interest in utilities and telecom as they favored riskier assets.

#### Large Growth

The Russell 1000 Growth Index rose nearly 5% in the first quarter. After a mostly negative start in January, equities rallied in February and March to close the first quarter in positive territory. While unemployment continues to dampen market enthusiasm, positive GDP and prospects for strong earnings growth provide a solid foundation for rising equities prices. Inflation has remained subdued and kept the Federal Reserve from having to increase short term interest rates. M & A activity increased for the period in a sign that equity valuations are becoming attractive. The consumer discretionary sector was among the top performing sector for the quarter as shoppers shrugged off the snow and worries about the economy to buy full-price spring clothing and other items at the nation's malls. The industrials sector also advanced as manufacturing activity expanded. Financials also fared relatively well despite proposed regulation which would impose restrictions on the size and scope of banks and other financial institutions to rein in excessive risk taking and to protect taxpayers.

#### Large Core

The equity markets corrected early in the first quarter on concerns over the durability of the global recovery in the wake of Chinese monetary adjustments, rising sovereign debt uncertainty and a pause in the progress of economic indicators. However, the markets regained their footing, driven by continued progress in the manufacturing sector and a substantial improvement in corporate profits. Inventory restocking drove much of the growth, followed by net exporters and consumer spending. Investors chose to focus on the positive aspects of the economic recovery, largely ignoring the weaker aspects of unemployment and real estate. The S&P 500 gained 5% for the quarter, to end at 1,169, though it remains 25% below its all-time high posted in October 2007. Corporate earnings came in stronger than expected, with 72% of the companies in the Index reporting fourth-quarter earnings that exceeded expectations. According to a Standard & Poor's survey, operating earnings for companies in the S&P 500 Index are expected to grow by almost 70% from the same period a year ago. Keep in mind, this annual comparison is against one of the worst quarters in history. However, this improvement in aggregate earnings estimates does signal a better economic environment for corporate earnings. The more economically sensitive sectors such as industrials, financials and consumer discretionary posted the best returns, while the more defensive utilities and telecom posted losses.

#### Mid Cap

Mid-cap stocks posted solid gains during the first quarter of 2010. Value stocks reclaimed leadership in the quarter, outperforming growth stocks across all market capitalization ranges. In the mid cap segment, the Russell MidCap Value Index, the Russell MidCap Growth Index and the Russell MidCap Index advanced 10%, 8% and 9%, respectively. The value index benefitted from stronger stock performance in financial services, consumer discretionary and consumer staples. Meanwhile, the defensive utilities sector was the largest underperformer in the value index. Top performing sectors in the growth index included healthcare, consumer staples and consumer discretionary. Similarly, the utilities sector was the notable detractor in the growth index, falling nearly 7% for the quarter.



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#### Small Cap Core

The equity market rally, which began over a year ago off of the market low, continued in the first quarter of 2010. While investors have generally come to embrace the economic recovery, their mood can perhaps best be described as cautiously optimistic. Concerns remain over the high unemployment rate and lack of job creation, as well as the credit-worthiness of sovereign nations around the globe. As is often the case in the early stages of an economic recovery, smaller capitalization issues led their larger capitalization counterparts as investors looked to capitalize on economic expansion. The Russell 2000 Index advanced 9% during the quarter as small cap stocks continued to march back. Meanwhile, the Russell 2000 Value Index gained 10%, while the Russell 2000 Growth Index rose 8%. Those sectors more economically sensitive, such as consumer discretionary, generally outperformed the traditionally more defensive sectors like utilities.

#### Small Cap Value

The first quarter of 2010 saw value outperform growth within the small cap segment of the market as another strong quarter for stocks extends the big rally that started in March 2009. For the quarter, the Russell 2000 Value Index advanced 10%, versus an 8% gain for the Russell 2000 Growth Index. Consumer discretionary, financials and information technology were among the top performing sectors, while utilities, energy and telecommunications services underperformed. Massive global government policy responses helped kick-start the economic rebound, with most economic indicators now in sharply improving trends. Although most economic news is much better, headwinds do remain, including a very large budget deficit and a fading economic stimulus package.

#### Small Cap Growth

The first quarter of 2010 saw growth underperform value within the small cap segment of the market. For the quarter, the Russell 2000 Growth Index advanced 8%, versus a 10% gain for the Russell 2000 Value Index. Consumer discretionary, consumer staples and healthcare were among the top performing sectors, while utilities, energy and telecommunications services underperformed. U.S. equity markets posted the best first quarter gains in over a decade. However, the market progress was less than orderly as a series of events rattled investor confidence. In Asia, Chinese authorities took steps to reverse economic stimulus by tightening lending standards. In Europe, investors worried that the debt crisis in Greece would spill over into Portugal and Spain. In the U.S., the signing of a landmark healthcare bill introduced fears of excessive government control. In the end, equities were bid up as concerns about these events gave way to enthusiasm for the improving functionality of financial markets.

#### International Equity

International developed markets posted varied results as the MSCI EAFE Index advanced 1%. Canada ended up 6% as the central bank left rates at a record low of 0.25%. The United Kingdom declined 1% as the Bank of England left interest rates at a historic low of 0.5%, where it has stood since March 2009. The U.K. economy continues to show mixed signals, but export growth and the local Purchasing Managers' Index (PMI) are showing some improvements from the prior quarter. The ECB left rates unchanged at a record low of 1% as the central bank remains in a holding pattern as questions surrounding a Eurozone recovery loom. Among the largest European markets, France and Germany declined 4% and 3%, respectively. In the Pacific region, results were mixed. New Zealand and Singapore declined 4% and 1%, respectively. Meanwhile, Japan and Australia rallied 8% and 4%, respectively. Japan was the notable standout as exports soared. However, Japan's ruling Democratic Party of Japan (DPJ) has suffered a series of cabinet scandals and corruption with most polls showing falling support of Prime Minister Hatoyama and the new DPJ government.

#### Emerging Markets

Emerging markets posted mixed results for the quarter, ending up 3%. Within Asia, China declined 2% as the central bank tightened monetary policy. China increased the reserve requirement on banks twice during the quarter in addition to forcing some banks to slow credit growth. India gained 5% despite an earlier-than-expected interest rate increase. Reacting to double digit inflation, the Indian central bank surprised the markets with a 25 basis point intermeeting rate hike. In Latin America, Brazil ended unchanged for the quarter on mixed results from commodity-related holdings. Brazilian iron and steel companies generally posted strong results, while select energy names underperformed. Mexico rallied 8% as the economy continued to emerge from last year's slump. Among the EMEA (Eastern Europe, Middle East and Africa) countries Russia rallied 7% on strength in banking and mining stocks. South Africa ended the quarter up 5%, supported by banks, though gold producers slid, hampered by production issues.

#### International Small Cap Equity

International small cap equities continued their march forward, ending the quarter with a positive return. Global markets started the quarter on a positive note, but peaked in mid-January as China started tightening monetary policy. Investor concerns about slower global economic growth and the looming effects of the debt crisis in Greece caused the markets to correct over the next several weeks. These concerns faded over the last month of the quarter as the expansion in the global economy helped to lift corporate revenues higher. Regionally, emerging markets stocks continued to lead the global rally. While both large- and small-capitalization stocks posted relatively good results during the quarter, small-cap international stocks generally outperformed larger-cap international stocks.



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#### Global Equity

The S&P 500 Index, the technology-heavy NASDAQ Composite and the Dow Jones Industrial Average advanced 5%, 6% and 5%, respectively. Gains were larger within the Russell 2000 Index of small companies, which advanced 9%. International markets posted varied results, with the MSCI EAFE Index ending up 1%. Among the largest European markets, Germany and France declined 3% and 4%, respectively. In the Pacific region, results were mixed. New Zealand and Singapore declined 4% and 1%, respectively. Meanwhile, Japan and Australia rallied 8% and 4%, respectively. Japan was the notable standout as exports soared. Australia's economy is benefiting from strong Chinese demand for commodities. In the emerging markets, the MSCI EM ended up 3% on strength from select Latin American, Emerging Asian and EMEA (Eastern Europe, Middle East and Africa) countries.

#### Commodities

Commodities retreated during the first quarter as the global economic recovery hit some rough patches on concerns that emerging market governments would take active steps to slow their economic growth. Energy posted losses primarily due to a drop in natural gas prices, which reacted to milder weather forecasts in key U.S. regions, weaker demand and increased supply. Crude oil gained 5% on growing confidence of a sustainable global economic recovery and reports indicating falling overall global supply. Grains suffered as USDA crop reports cited abundant global supplies of wheat and corn. The softs sector was hurt by large declines in sugar prices, which tumbled as output from Brazil and India increased much more than expected. Industrial metals posted gains as robust U.S. manufacturing data and record high Eurozone industrial output boosted demand expectations. Nickel surged as stockpiles declined and users were buying nickel to ensure future inventories. Gold was largely range bound for the quarter, closing the period modestly higher at \$1,113 an ounce on continued strong demand from India and concerns of higher inflation.

#### Real Estate

U.S. REITs gained 10% for the quarter, driven by improving economic conditions and continued access to capital markets at attractive costs. This credit at reasonable prices has removed the implied "distress" faced by many companies, though it also allows sellers of real estate to be more patient. Well positioned REIT balance sheets and a healthy IPO pipeline position REITs to be aggressive acquirers of assets. REITs reported earnings have generally met expectations. Across most property types, fundamentals appeared to have found a bottom with vacancies seeming to have peaked and rents to have stabilized. Two dominate themes took place during the quarter. The first was the outperformance of early cyclical companies. Retail and lodging performed particularly well on hopes these areas stand to benefit more immediately from an improving economy but also from the unfolding bidding war for mall REIT General Growth's properties. The other theme was a broad compression in cap rates, which especially benefited highly leveraged companies. From a regional perspective, cap rate compression was most visible in New York City and Washington D.C. REIT dividend yields ended the quarter at 3.9%, and are well supported by underlying free cash flow yields of 5%.

#### International Real Estate

Foreign REITs were mixed. European property companies, especially in the U.K., continued to struggle with political and fiscal uncertainty. Concerns over Greece's budget crisis and its wider implications weighed heavily on European REITs, though the region had some relief in March, when a joint rescue agreement by the EU and the IMF appeared imminent. Signs point to optimism in the U.K. as prime office buildings have seen significant rental growth. France's office market is facing growing supply and rental price pressure, while the retail sector is seeing positive rental trends. Asia-Pacific was flat to negative for the quarter on concerns potential policy tightening measures would stem asset price appreciation. Japan's real estate securities lagged their Asia Pacific counterparts, though indications hint the bottom may be in sight as increased liquidity by the BOJ enables J-REITs to expand their portfolios. The strength of Hong Kong's luxury residential market has raised concerns about housing affordability. Across most markets, property companies continued to benefit from an improved economic outlook and abundant liquidity.