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## Asset Class Summaries

### Second Quarter 2010

#### Fixed Income

Treasuries rallied and risk premiums widened amid a “flight to liquidity” on fears over a destabilized European banking system, a weaker tone of U.S. economic data, and policy restraint in emerging markets. Concerns for slow growth and deflation took hold driving the Treasury curve considerably flatter. TIPS gained despite continued near-term disinflationary pressures weighing on market sentiment, but underperformed comparable maturity nominal bonds overall. Corporate spreads widened as systemic concerns weighed on all risk assets, overshadowing improving fundamentals as evidenced by declining leverage, improved liquidity and lower default risk. Agency MBS performed well after the end of the Fed purchase program. Favorable supply versus demand technicals continued to buoy MBS, while the implicit government guarantee provided credit support. The credit metrics of credit card and auto ABS continued to show solid improvements with delinquencies falling sharply and underwriting standards improving. CMBS posted gains supported by signs of lending liquidity returning to the market.

#### TIPS

TIPS gained despite continued near-term disinflationary pressures weighing on market sentiment, but underperformed comparable maturity nominal bonds overall. Real yields were mixed with short-maturity real yields increasing 40-50 bps, while long-maturity real yields fell 20-40 bps. The fall in near-term inflation expectations drove the short end to compensate new buyers for the loss of anticipated inflation carry, while longer-term real yields were supported by concerns about European sovereign debt risk. Breakeven inflation levels fell 35-100 bps to their lowest levels of the year, with the bellwether 10-year breakeven rate ending June at 1.8%.

#### Munis

Municipals edged higher as the fear of rising taxes trumped growing concerns about deteriorating finances at the state and local level. Credit issues moved to the forefront as a major issue in the municipal market. Performance became even more bifurcated over the period among different issuers depending on their credit situation. Spreads tightened for higher quality bonds and widened for lower quality issuers with severe budget problems. Municipal yields moved lower across the curve with shorter maturities falling more than longer maturities. The sharp declines in Treasury yields moved municipal ratios closer to 100% across the maturity spectrum. Taxable Build America Bonds (BABs) fared well as investors viewed them as an attractive substitute for corporate credit exposure. BABs fate was delayed in Congress as policymakers debate various aspects of the program, which may drive municipalities to increase issuance of BABs to take advantage of the interest subsidy while it's still available.

#### Foreign Bonds

Sovereign debt rose, led by Japan, Germany and the U.K. as investors sought refuge from peripheral Europe's debt problems. The U.K. bond market responded well to dovish comments, while Japan's economic data pointed towards a recovery in exports and business sentiment. Yields on Greece, Spain and Portugal spiked as they struggled to implement debt reduction plans. All three suffered credit rating downgrades. Currency losses offset much of the bond gains. The U.S. dollar and Japanese yen appreciated broadly during the quarter with investors seeking safety. The euro declined sharply on fears of a breakup, banking stress and expectations of an economic slowdown. Escalating global credit fears and calls for deficit reduction measures in Europe and monetary tightening in Asia resulted in spread widening in the foreign corporate bond sectors. Despite strong fundamentals, demand for emerging market debt abated due in part to concerns over slower growth in China as well as a general reduction in risk appetites. Emerging sovereigns continue to benefit from lower debt levels and smaller fiscal deficits.

#### High Yield

High yield spreads widened as systemic concerns weighed on all risk assets. The market focused on ongoing macro concerns and the potential for slowing global growth, which overshadowed improving fundamentals including declining leverage, improved liquidity and lower default risk. Spreads ended June at 700 bps over Treasuries, after peaking at 1,662 in March 2009. New issue supply declined though is still on pace to surpass 2009. While the majority of new supply was used for refinancing purposes, a good chunk was issued to supply acquisitions, a trend expected to continue. In terms of demand, mutual funds saw significant outflows amid a flight to quality trade. Downgrades by rating agencies slowed and default activity remained low with only 22 companies defaulting in the year's first half. Financials fared worst due to regulation uncertainty, while energy dealt with the oil spill and drilling moratorium. Higher-rated issues fared best as risk contagion hurt lower quality and higher beta issues.

#### Balanced

Improving corporate profits and manufacturing data were not enough to offset fears over the debt problems in Europe, slowing growth in China and mixed U.S. economic data. Additional distractions included uncertainty surrounding tighter financial and energy regulations in Congress, the SEC's filing of fraud charges against Goldman Sachs, the growing severity of the Gulf of Mexico oil spill and lackluster domestic employment growth. Investors had limited opportunities to maneuver this quarter, with pressure seen across the board. Areas less dependent on economic conditions held up best. Treasuries rallied and risk premiums widened amid a “flight to liquidity”. Concerns for slow growth and deflation took hold driving the Treasury curve considerably flatter. Corporate spreads widened as systemic concerns weighed on all risk assets, overshadowing improving fundamentals. Favorable technicals as well as improving credit metrics continued to buoy MBS, ABS and CMBS.

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#### Broad Equity

U.S. equity markets ended sharply lower in the second quarter as investors shunned risky assets as the strength and sustainability of the economic recovery was called into question. Concerns escalated about the Eurozone sovereign debt crisis and the potential it could hamper U.S. growth. Meanwhile, the economic fallout from the BP oil spill disaster remains uncertain. The spill, which is estimated to have leaked millions of barrels of oil, has become the worst in U.S. history and surpassed the Exxon Valdez disaster off the coast of Alaska in 1989. For the quarter, the S&P 500 Index and the Russell 2000 Index of smaller companies declined 11.4% and 9.9%, respectively. Consumer staples, telecommunications services and utilities were among the top performing sectors, while energy, materials and financials underperformed. No investment style emerged as a favorite as growth fared best among small-caps, but trailed among mid- and large-caps. Meanwhile, small- and mid-cap companies fared slightly better than larger companies.

#### Large Value

The Russell 1000 Value lost 11% for the quarter. Investors shunned risky assets as the strength and sustainability of the economic recovery was called into question. U.S. economic data revealed a soft patch, but nonetheless was largely positive. Concerns grew, however, about global events and their potential harm to U.S. companies and domestic growth. The U.S. dollar's strength weighed on larger companies with foreign revenue exposure. Every sector posted a loss for the quarter, with the demand sensitive materials sector hardest hit. Energy and financials also posted steep losses amid concerns about the fallout from the oil spill in the Gulf of Mexico and pending financial reform efforts. Utilities and telecom held up best due to their less economically-sensitive earnings and higher yields. General Electric was the worst performer in the index as it faced the twin pressures of slowing global growth and potential financial reform.

#### Large Growth

The Russell 1000 Growth Index declined nearly 12% in the second quarter. Volatility was reintroduced into the stock markets during the second quarter as sovereign debt risk reared its head once again. The backdrop of economic growth/stability and market complacency experienced earlier this year was shattered in May and June as global equity markets fell sharply amidst concerns of a double dip recession. Traditionally defensive areas such as the telecommunications services and utilities sectors were among the best performers as investors sold riskier assets and flocked to safety and yield. The financial services sector plummeted as reform legislation loomed. Lawmakers seek to pass the most sweeping regulatory overhaul of the financial system since the Great Depression and expect that some type of financial regulatory reform will be finalized later this summer. The materials sector was hard hit as companies reduced manufacturing amid a worldwide slowdown in demand. Energy shares moved sharply lower in the wake of the BP oil disaster in the Gulf of Mexico.

#### Large Core

The S&P 500 fell 11% in the quarter to end at 1,031. The recent sell-off was broad based with all 10 sectors posting losses for the quarter and only 72 companies posting gains. Improving corporate profits and manufacturing data were not enough to offset fears over the debt problems in Europe, slowing growth in China and lackluster domestic employment growth. Additional distractions included uncertainty surrounding tighter financial and energy regulations in Congress, the SEC's filing of fraud charges against Goldman Sachs, and the growing severity of the Gulf of Mexico oil spill. Fears the U.S. could be headed for a double-dip recession resurfaced. However, current markets are quite different from 2008 when economies were contracting and corporate earnings were weakening. Today, global economies are improving on the whole, non-financial corporate balance sheets are generally on solid footing and banks are rebuilding their capital. The S&P 500 now stands at about 11 times next year's \$93 consensus estimate of net income from operations, and yields 2.2%. Earnings continued to recover with 82% of companies reporting positive surprises. Investors had limited opportunities to maneuver this quarter, with pressure seen across the board. Areas less dependent on economic conditions such as the telecommunications services and utilities sectors held up best as investors sold riskier assets and flocked to safety and yield. On the flip side, areas with strong ties to the global economic recovery such as consumer discretion, industrials and materials were hard hit on concerns of a slowdown. Banks and financial stocks sold off as investors feared the impact of reform.

#### Mid Cap

Mid-cap stocks posted losses during the second quarter of 2010. No investment style emerged as a favorite as growth fared best among small-caps, but marginally trailed among mid- and large-caps. Meanwhile, small- and mid-cap companies fared slightly better than larger companies. In the mid cap segment, the Russell MidCap Value Index, the Russell MidCap Growth Index and the Russell MidCap Index declined 9.6%, 10.2% and 9.9%, respectively. The value index benefitted from stronger stock performance in utilities, telecommunication services and consumer staples. Meanwhile, the consumer discretionary sector was the largest underperformer in the value index. Top performing sectors in the growth index included healthcare, consumer staples and telecommunication services. The energy sector was the notable detractor in the growth index, falling over 19% for the quarter.

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#### Small Cap Core

The Russell 2000 Index lost 9.9% during the quarter as small cap stocks declined. Meanwhile, the Russell 2000 Value Index fell 10.6%, while the Russell 2000 Growth Index ended down 9.2%. Those sectors more economically sensitive, such as consumer discretionary, generally underperformed the traditionally more defensive sectors like utilities. Global stock markets slid during the quarter as investors shunned risky assets. The Eurozone debt crisis rattled the markets and threatened to derail the region's fragile economic recovery. Meanwhile, the sustainability of China's pace of growth was called into question as authorities attempted to tap the brakes on the economy and curb speculation in real estate.

#### Small Cap Value

The second quarter of 2010 saw value underperform growth within the small cap segment of the market. For the quarter, the Russell 2000 Value Index declined 10.6%, versus a 9.2% loss for the Russell 2000 Growth Index. Telecommunications, utilities and consumer staples were among the top performing sectors, while consumer discretionary, materials and energy underperformed. The rally that began in the equity markets off of the March low over a year ago stalled. Just as investors seemed to be embracing the budding economic recovery, macroeconomic fears returned to the forefront to give investors pause. The potential of a sovereign debt crisis in Europe, fear of a continued economic slowdown in China, continued high unemployment in the U.S., the environmental disaster in the Gulf of Mexico and ever-increasing regulation out of Washington D.C., combined to shake the confidence of investors.

#### Small Cap Growth

The second quarter of 2010 saw growth outperform value within the small cap segment of the market. The risk rally that began in March of last year reversed during the period amid serious economic problems in Greece, fear of spreading European contagion and slowing Chinese growth. Further regulation of financial markets and the systemic risk revealed in the "flash crash" in May also rattled investor confidence. For the quarter, the Russell 2000 Growth Index declined 9.2%, versus a 10.6% loss for the Russell 2000 Value Index. Industrials, consumer staples and information technology were among the top performing sectors, while consumer discretionary, energy and healthcare underperformed.

#### International Equity

International developed markets posted mostly dismal results as the MSCI EAFE Index declined 14%. Canada fell 10% as the Bank of Canada raised interest rates by 25 basis points to 0.5%. The United Kingdom plunged 14% as the Bank of England left rates unchanged at a historic low of 0.5%. In the U.K., David Cameron, leader of Britain's conservative party won the election. The European Central Bank left interest rates unchanged at a record low of 1% during the quarter as questions surrounding a Eurozone recovery loom as sovereign debt concerns continue to plague the region. Eurozone retail sales remain weak, unemployment rose to its highest level in nearly 12 years and consumer spending remains tepid. In the Pacific region, Australia and Japan fell 19% and 10%, respectively. Meanwhile, Hong Kong declined 6%, while Singapore ended unchanged.

#### Emerging Markets

Emerging markets posted mostly lower results for the second quarter with the MSCI EM Index falling 8%. In Asia, China declined 5% as officials proposed yuan exchange rate flexibility. Elsewhere in Asia, South Korea declined 8% as ongoing political tensions with North Korea after the March 29<sup>th</sup> sinking of a ship continue to dampen the market. The smaller markets of the Philippines and Indonesia fared much better, rising 3% and 5%, respectively. Within Latin America Brazil plummeted 15%, weighed down by energy-related holdings. Mexico's stock market also came under pressure, ending down 9%. Among EMEA countries, South Africa declined 10%. In the Middle East, Turkey fell 4%, while Egypt lost 13%. Markets in Eastern Europe posted double-digit declines, mired by fears about the spread of Europe's sovereign debt crisis. Russia and Poland fell 15% and 22%, respectively.

#### International Small Cap Equity

International small cap equities ended the quarter with negative returns. Global markets fell sharply as Europe's sovereign debt crisis and credit tightening in China cast a shadow over the world's economic prospects. Although the EU and the IMF announced unprecedented financial rescue packages to prevent a sovereign debt default, investors appeared to fear that the measures might fail unless accompanied by far-reaching economic and institutional reform. While both large- and small-capitalization stocks posted relatively dismal results during the second quarter of 2010, small-cap international stocks generally outperformed larger-cap international stocks.

#### Global Equity

For the quarter, the S&P 500 Index and the Russell 2000 Index of smaller companies declined 11% and 10%, respectively. International markets posted negative results, with the MSCI EAFE declining 14%. Among the largest European markets, France and Germany declined 18% and 12%, respectively. Within the Pacific region, Australia and New Zealand fell 19% and 11%, respectively. Meanwhile, Japan declined 10%, while Singapore ended unchanged. On the political front, Japanese Prime



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Minister Yukio Hatoyama resigned just months after taking office amid broken campaign promises and a political funding scandal. Hatoyama was Japan's fourth prime minister to resign in four years and was replaced by Naoto Kan. In the emerging

markets, the MSCI EM fell 8% on weakness from select Emerging Asian, Latin American and EMEA (Eastern Europe, Middle East and Africa) countries.

#### Commodities

Commodities declined 5% during the quarter as expectations for global growth were reset lower. Industrial metals and energy were pressured by a stronger U.S. dollar and growing concerns of credit tightening in China. Rising petroleum inventories further weighed on energy. However, losses in the energy sector were somewhat offset by higher natural gas prices that were supported by warmer weather in most U.S. territories and rising tropical activity in the Caribbean. Softs and precious metals were the bright spots. Softs gained mainly due to a rally in coffee prices as Colombian production underperformed 2010 expectations. Precious metals benefited from safe-haven demand for gold driven by continued currency uncertainties and worries about the debt crisis in the Eurozone periphery.

#### Real Estate

U.S. REITs lost 4% for the quarter though held up better than the broader markets. They initially rose, extending a rally fueled by signs that conditions for REITs were improving, in some cases significantly faster than expected. The group reversed course in May, however, as macro-economic headwinds brought into question the trajectory of the economic rebound. Property fundamentals continue to improve and capital markets remain wide open. While most sectors experienced weakness, apartments posted gains, benefiting from a recovery in demand and rental rates. Offices were mixed, as those REITs focused on suburban markets struggled. Hotels fell sharply amid heightened sensitivity to shifts in economic sentiment due to their ultra-short term leases. Shopping centers also underperformed as consumers continued to cautiously spend. A delayed recovery in demand amid a weakened economic outlook weighed heavily on the industrial sector. REITs ended the period yielding 4.2%.

#### International Real Estate

Despite improving fundamentals, international REITs declined 10% for the quarter. European markets fell sharply on concerns the sovereign debt crisis could lead to a tighter lending market and wider regional contagion. In addition, many continental European countries are home to pan-European retail companies whose portfolios include malls and shopping centers in southern Europe, where valuations face the most pressure. The U.K. declined on fiscal uncertainty amid a new administration's proposed cutbacks. Demand for offices is beginning to improve throughout Europe, though tenants remain cautious and cost sensitive. A notable exception remains London, where rents are showing growth and expected to improve further. Even with improving economic outlooks and abundant liquidity, Asian markets were pulled down by increasing risk aversion likely driven by concerns China's economy is cooling. Hong Kong fell on potential administrative policy to stem rapid asset price appreciation, particularly in the luxury residential market. Singapore struggled with concerns of administrative meddling to slowdown its red-hot residential sector, while Japan declined as vacancy rates and rental rates deteriorated, albeit at a slower pace.