Aureus Asset Management
Asset Allocation
Our Outlook for 2011 and Beyond

Introduction

We view 2011 as a year of continued positive growth economically but also as a year of increasing geopolitical volatility. These conditions support our view that an intelligently-diversified portfolio with the flexibility to capitalize on meaningful opportunities is the appropriate approach for our clients.

In the US and Europe, growth is being fueled by a resurgence of the private sector from the low levels of 2008-9. However, the hangovers of too much debt and ballooning budget deficits affect Europe, Japan and the US. In contrast, emerging world countries have substantial central bank reserves and above-average growth prospects, but need to tackle a problem of supply constraints leading to higher inflation. These nations are adopting tighter monetary policies, such as slower loan growth and higher interest rates, but must be careful not to choke the growth enabling their economic transformations.

These challenges must be met in the same coordinated manner that the world dealt with the US subprime and financial assets crisis. Delaying, or failing to reach agreement, increases the odds of renewed economic and geopolitical disruption. Our asset allocation model for 2011 assumes that our primary challenges will be addressed in a coordinated fashion, even if advances seem at times slow and halting. More than ever, we will watch for progress and will be prepared to make tactical changes to asset allocation.

Having analyzed valuations and growth prospects for varying asset classes, we believe the current environment encourages more investment in risk assets such as equities, especially in the US, and commodities. High quality fixed income appears less attractive in the short term. For investors with long-term time horizons, illiquid asset classes, such as venture capital, seem more appealing today than they have in recent years.

Interconnected World

Today, almost every economy is connected to every other one. The value of the Chinese currency influences the policies of not only the US but also those of European and South American countries, just as the European debt problem (and how and when it will be resolved) affects the US Treasury market and flows into the euro and yen.

Growth in the US and many leading European countries has improved. In the US, banks are lending more actively, the stock market has recovered nicely from the lows of March 2009,

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consumers are spending more aggressively and business leaders are raising plans for expansion. With the single but important exception of residential and commercial construction, every area of the private sector in the US demonstrates a rising level of growth. Best of all, corporate profit margins are back to pre-recession peaks, helped by excellent productivity and strict cost control. US reported earnings were up close to 30% last year, double the rise in the stock market, thereby lowering price-earnings multiples to under the long-term historical average.

The most important challenge facing the US is its gap between tax revenues and government expenditures, which is close to an all-time high as a percent of GDP. Last December, the deficit reduction commission produced a detailed and honest report which laid out the blueprint for bringing our deficit into line. In 57 pages, the report told us how the country must cut spending and raise tax revenues in order to achieve our goal, with particular attention to the enormous gap between the entitlements (Social Security, Medicare, Medicaid, and other benefits programs) which have been promised and the lack of income to support those promises.

Unfortunately, the response from almost all Republicans and Democrats has been evasive. Either our politicians have to move towards a grand compromise, as laid out by the deficit reduction commission report, or they will eventually be forced into it by a bond market fed up by inaction, and threatening much higher interest rates.

In Europe, the larger economies are growing fairly well, and major exporters such as Germany are taking full advantage of the weaker euro. In southern Europe growth remains subdued and debt levels extremely high.

The European debt problem is even more important than in the US, especially given the excess reliance on short-term sovereign debt rollovers, which will reach over 500 billion euros in 2011. Very few people believe that Greece, Ireland, Portugal and possibly Spain can meet their obligations to creditors while also enforcing many years of austerity on their citizens. Default is likely, even if it is referred to using more neutral terms such as “restructuring” or “adjustment”. In turn, default means having to restore capital cushions to many European banks, particularly in Germany and France, where current capital ratios are far less healthy than comparable US banks. Until politicians face up to this challenge, instead of deferring it as has been the case up to now, we expect the situation in the Eurozone to be a source of continued anxiety for financial markets.

The developed world is in the painful process of realizing how hard it will be to solve today’s debt/deficit problems, which demand honesty and willingness to make very tough choices. We expect volatility in financial markets to remain high until these problems have been debated and eventually resolved.

The Emerging World

Growth is still high for the major countries of the emerging world, from 4-5% in Brazil to as much as 9-10% in China. Valuations, while well above recent lows, seem in line with economic realities. However, inflation has become a key near-term problem, especially in food and energy. Since many emerging countries spend close to half their GDP on food and energy, where supplies are especially tight, price inflation is rising rapidly.

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The surge in liquidity in China, India, Brazil and other countries in 2009, was a response to fears of economic slowdown. Today, central banks in these nations are grappling with inflation and speculation resulting from accommodative policies. Many emerging countries now are responding through tighter monetary measures, which result in rising interest rates and slower growth of money supply.

As the emerging world gradually tightens its economic policies, there is a risk that such measures could backfire, by producing a greater slowdown than expected. A policy of currency appreciation, of course, would help to restrict inflation, provide greater incentives for domestic consumption and alleviate the need to force tighter monetary and fiscal policy measures. Another source of inflation relief would be a normal harvest this summer, if weather returns to more typical patterns.

The threats of inflation and of tightening economic policies are very much focused on the short term. Long term, we are still very attracted to the growth prospects of such countries as India, China and Brazil.

The World as a Whole

Political freedom is also a potential flash point. The troubles in Libya, Egypt and Tunisia, where initial unrest arose from food prices and was then followed by more general protest, tell us that the combination of inflation and political repression in the emerging world can bring major unrest. As the world moves towards greater political and economic freedoms, spurred by the growing power of people connected by the Internet and less willing than before to accept repressive rule, there will be volatility in governmental responses. Not every challenge may be met peacefully. We need to be alert both to the long-term opportunities which will arise from more open societies and to the short term setbacks which may occur as governments resist this trend.

Base Case Model

After a complete bottom-up quantitative and qualitative reassessment of 20 years of data for 21 different asset classes and geographies, revising adjustments to return expectations, time periods, correlation metrics, and exposure ranges, we established the appropriate data with which to update our base case model. The chart below illustrates our base case allocation recommendations; comments on each major asset class follow:

- *Core Equity:* We have increased our weight to US equities. In a world of major uncertainty, the US remains a safe haven. More important, US stocks are reasonably valued on current earnings, and US corporations have strong balance sheets and high profit margins. Growth in the US should be faster than any other country in the developed world.

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- *Hedged Equity:* We maintain a substantial commitment to highly specialized long/short equity managers. Each manager is a specialist in either a single industry or a single area of market capitalization, such as small cap. Managers who use hedging strategies appropriately can mitigate short-term market volatility, while participating in much of the market's potential upside.

- *Europe and Japan:* We remain significantly underweighted, awaiting resolution of Europe's debt problems and Japan's challenges of a stagnant population and economy.

- *Commodities:* We divide our commodity exposure about 50/50 between energy and metals. The oil market benefits from growing demand in the emerging world, as do industrial metals. Precious metals, such as gold or silver, benefit from market uncertainty.

- *Emerging Markets:* While the long-term prospects for the developing world remain very positive, the short-term pressures from inflation have caused us to hold off adding to any further exposure in this area, until we can see stabilization of monetary and fiscal policy in such countries as China and India.

- *Fixed Income:* We have cut back on high quality bond exposure, believing that current interest rates do not reflect potential inflationary pressures. On the other hand, we maintain significant exposure to credit focused managers, who are in a position to take advantage of relative mis-pricing of such assets as distressed debt or asset-backed securities.

- *Illiquid Assets:* For the first time since Aureus was founded in 2005, we are including illiquid assets in our model, whereas up to now we had felt this investment area lacked appeal. The combination of far less capital being directed to this asset class and better deal pricing persuades us that venture capital and other forms of illiquid assets finally hold promise. For clients with the ability and desire to sacrifice near-term liquidity for the promise of superior long-term returns, we believe that this asset class is now priced attractively.

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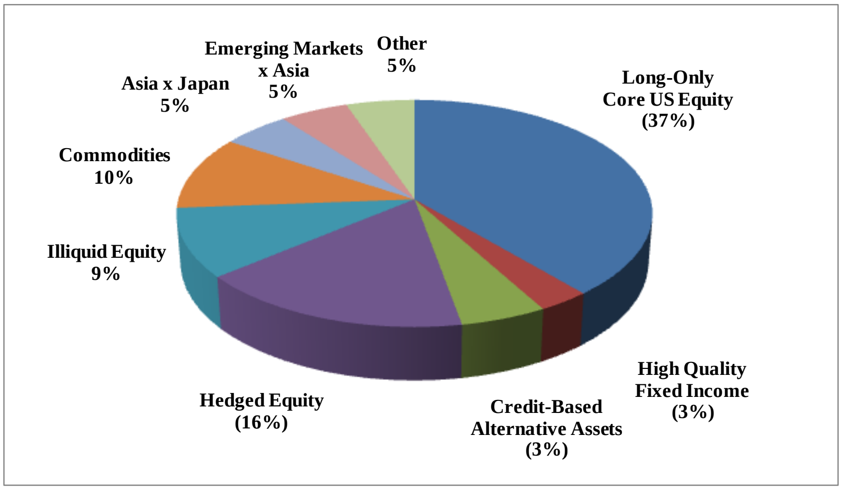
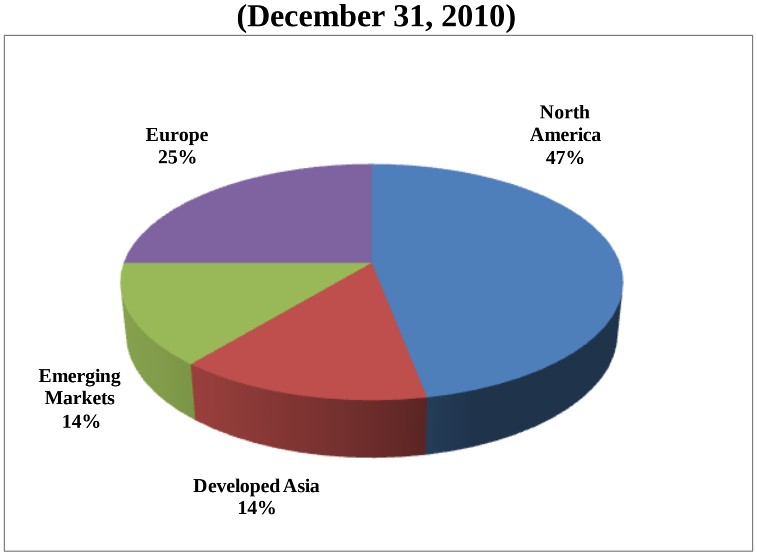
The following chart reflects the Aureus base case asset allocation for 2011.

2011
Base Case Asset Allocation



This base case deals with many different asset classes. Liquid equities, which are represented in several of the categories (core US equity, hedged equity, emerging markets, Asia ex Japan, and other), are the largest single area of concentration. Below we show how the world's equity market capitalization is divided between key geographical areas. Note that the US is less than 50% of the world, that Europe is one-quarter, that developed Asia is 14% which exactly matches the capitalization of all the emerging countries. Today, we want to emphasize the US, substantially underweight Europe and developed Asia, and maintain our emphasis on the emerging world.

Global Equity Market Capitalization by Geography
(December 31, 2010)



Source: MSCI AC World Index Weightings as of 12/31/10

The expected annualized return for our base case model over a two-year period is approximately 7.6%, with a standard deviation of 10.5%. Importantly, the 7.6 % return is nominal, meaning gross of inflation. While inflation has been of little concern in the past few years, being well below long term averages, we now think that improving private sector growth, easy money in the developed world, and supply constraints in many commodities will start to be reflected in inflation figures. From a low of only 1 ½% in the US, for example, we believe that inflation could slowly rise towards 3%. In the emerging world, inflation already is in the 4-7% range. As inflation picks up, we may have to revise our return estimates if the world is slow to react.

Markets continue to be fluid and constantly reflect circumstances germane to that particular moment in time. Challenges faced in the global economy are significant and are interrelated. We continually review our projections to ensure they remain current, making tactical shifts in asset allocation as we believe prudent.

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