Capital Markets Quarterly

KEY DATA:

ECONOMIC GROWTH:

Stat	1Y	10Y
GDP*	4.1%	4.0%
Real GDP*	2.0%	1.6%
CPI	1.7%	2.4%
Core CPI	2.2%	1.9%

FIXED INCOME (BC AGG):

Index	Now	Avg.**
Yield	2.0%	7.5%
Coupon	3.8%	7.6%
Duration	5.1	4.8
Spread (bps)	77.0	56.0

US EQUITIES (S&P 500):

Index	Now	Avg.**
EPS Growth	7.1%	4.8%
Div. Yield	2.1%	4.5%
P/E (TTM)	15.2	16.1
CAPE	21.0	16.5

INTL EQUITIES (EAFE):

Index	Now	Avg.**
EPS Growth	-11.5%	8.4%
Div. Yield	3.8%	2.2%
P/E TTM	11.4	19.4

** Trailing Twelve Months*
** * Represents the average over the entire period data is available*

Introduction

The world is an ever changing place; it always has been and always will be. There is a constant ebb and flow that one needs to adapt to in order to succeed. Sometimes the changing world is for the better. The industrial revolution shifted our societies from agrarian cultures to those able to focus on innovation and modernization. Other times the world changes for the worse, as when the world was thrown into a long lasting global conflict that sacrificed approximately 4 percent of the global population to end the tyranny of the Axis powers.

Although each one of the events is distinctly different, there were specific winners and losers in each event. During the urbanization and industrialization of the U.S., many businesses that were centered on specific occupational trades (i.e. black smiths) experienced monumental setbacks, as the advancement of assembly lines and mass production began to dominate the American business landscape. On the other hand, World War II provided the opportunity for an industrialist to prosper and help in the cause to defeat tyranny. Henry Kaiser used his experience in production to establish a shipbuilding yard that had the ability to build Liberty ships in less than a week. His efforts were not only monumental in ending a devastating time in world history, but the fortune he made established one of nation's largest healthcare networks.

Today's world is going through another transformation: moving from a rapidly growing world driven by the expansion of leverage to a world struggling with slow growth amidst a massive deleveraging cycle. With this environment, the world has experienced a great deal of uncertainty, causing investment markets to lurch back and forth. This type of return environment makes it extremely difficult for investors to achieve their long-term objectives, as increased volatility combined with increased correlation across asset classes decreases an investor's patience and increases the desire to make changes to their investment program. This desire to change is purely reactionary and is defined by Warren Buffet as emotional corrosion. Highland believes that overcoming this emotional corrosion is the most difficult thing for investors to accomplish; however, setting up a proper framework for making investment decisions can help investors.

At Highland, our process begins with a comprehensive review of the specific needs of each investment program (foundation, operating portfolio, pension, etc.). This review (both initial and ongoing) seeks to identify the objectives and constraints of each portfolio in order to provide the basis for the return needs and risk tolerance of the organization. Having a firm understanding of the objectives and constraints of each portfolio prior to setting the asset allocation allows the organization to weather difficult markets without the urge to make reactive changes to the allocation.

From a capital market perspective, our framework is based on examining the fundamental drivers of investment returns across asset classes. Next, we look at the current state of each market's fundamentals compared to both its own history and to all of the other asset classes in order to derive a future expectation of return. While others in our business also use this process to determine how to position portfolios, this is only the beginning of our process. Highland also believes that investment markets are not only driven by fundamental value, but also a long-term macro-economic direction that often pushes markets into secular directions (either bull markets or bear markets). For example, the urbanization and industrialization period described previously resulted in massive business expansion and produced nearly a quarter century of expansion.

We spend a large amount of time and effort in order to gain a realistic point of view on the secular macro environment in order to properly position portfolios for the future. We believe that this is of utmost importance in the design of a portfolio; therefore, this letter will address how we see the current macro-economic environment and how it impacts the asset allocation of an investment portfolio. It should be noted that these are Highland's broad market themes and that the exact application for each organization and portfolio will differ based on its unique objectives and constraints.

Macro-Economic Environment

The macro-economic environment of today's world is interconnected and complex. In order to build a realistic understanding of the future path, an objective examination of the pieces must be completed. While this is a tedious and difficult task, it must be done or one can quickly be led astray by the mainstream or misinformation.

U.S. Economy

The world's largest economy continues to struggle with aftershocks of the global financial crisis. Although the recession technically ended in 2009, most of the economic participants continue to feel as if no improvement has been made. There has indeed been progress, but the advances have been muted by structural issues faced by the nation. The laundry list of issues is extensive; however, Highland focuses on a few that we believe are the major problems that the nation must address before self-sustaining growth can return.

As the "Greatest Generation" dug the country out of the depths of the Depression and World War II, the nation was led on a path of prosperity that was built on advances in labor productivity and technology combined with low levels of leverage. As successive generations began to assume leadership in the country, the memory of the last financial crisis faded and the debt levels in the economy began a prolonged march to unsustainable levels, reaching a peak of nearly $55 trillion (or 382 percent of GDP). Since then, Private sector debt has been reduced by over $4.5 trillion (or 29 percent of today's GDP). While this is a good start to the deleveraging process, the public sector has been adding debt, which has increased the absolute level of debt. On a percentage of GDP basis, the leverage level has dropped to 350 percent, which has been accomplished by the general economy growing faster than the aggregate level of debt.

Another structural issue facing the U.S. is the current state of the workforce. The financial crisis resulted in approximately 8.8 million workers losing jobs. Since the recovery has started, over 3.8 million of these workers have rejoined the ranks of the working, but this is woefully inadequate to return the country to full employment. Not only has the level of employment changed, but the type of employment has gone through a long-term transformation, switching from a "brawn" economy focused on production to a "brains" economy centered on service oriented labor. The addition of service jobs to the overall economy is not all bad, as it allows for the labor force to upgrade its standard of living and provides a substantial boost to consumer spending. However, it opens the economy to global competition as there are very few barriers to entry. This ultimately puts a ceiling on the overall economy's standard of living as outsized profits will be squeezed down by new entrants.

Transitioning our labor focus more closely to a balanced position would be beneficial for the nation and could provide a boost to an economy that continues to struggle. While this is easy to say but difficult to execute, there is evidence that U.S. manufacturing is becoming more attractive than overseas competitors. According to studies by the Bureau of Labor Statistics (BLS), the U.S. has gained tremendously in marketability on a global scale, as wages have fallen (on a relative basis) to approximately middle of the pack in the global manufacturing arena. This along with the premiere positioning the U.S. has as one of the most productive nations in the world, has led to several major corporations (i.e. Caterpillar, Dow Chemical, GE, etc.) relocating some of their manufacturing back to the U.S.

The last structural concern for the U.S. is the political landscape and fiscal irresponsibility. Politically, each of the nation's major parties has been entrenched in a political war with one another since the end of Reagan's presidency. This war is evidenced by Congress' refusal to compromise and can be illustrated by the percentage of Representatives who vote with the majority of their party. This statistic (according to voteview.com) has been on the rise since the early 1980s, reaching the highest level since the early twentieth century (both the Senate and House have been voting with their respective party over 90 percent of the time). This unwillingness to work across the aisle has made it difficult to address many of the nation's issues (i.e. entitlement reform, tax reform, healthcare legislation, infrastructure spending, financial regulation, etc.). The resulting gridlock has reduced the global confidence that our nation can fix its fiscal issues in a prudent manner and pushes our nation one step closer to reactionary decision making that can do more harm than good.

International Developed Economies

The Eurozone debt crisis continues to take center stage in today's twenty-four hour news cycle. While all of the issues surrounding this debt crisis are very real and important, Highland believes that the debt crisis as a symptom of deeper underlying structural issues. The European Union in its current form is not structurally sound because the creation of the Euro eliminated a self-correcting mechanism that allows countries to more easily deal with their economic problems: a fluctuating currency.

With a floating currency, a country has the ability to counter-act its economic decline with a depreciating currency. In a simplistic example, a country that has over-levered and made poor fiscal decisions which have left its economy in poor condition will generally experience currency depreciation. This decline in currency value will actually cause the goods and services of that country to be more attractively priced on a relative basis versus other countries competing in the global marketplace. The result would be increased exports, which will increase the underlying economic activity of the country and allow more time to adjust the country's fiscal discipline.

In the case of Euro countries, this self-correcting mechanism is not in place making it much more difficult for weaker countries to improve. In fact, the stabilized currency will actually siphon economic activity from the weaker economies (i.e. Portugal, Italy, Greece, Spain, etc.) to the stronger economies (i.e. Germany, Austria, Belgium, etc.). The weaker economies have no choice but to plead to the union for debt relief and institute austerity measures in order to stabilize their economic situation. This in-turn has a negative effect on economic activity, causing the problems to worsen and creating a downward spiral.

Beyond treating the symptoms, there are two ways (both extreme cases with far reaching implications) in which the underlying structural issue can be reformed. The first would be elimination of the Euro. Although this would reinstate the self-correcting mechanism, the short-term challenges would be severe. Europe would most likely fall into a deep recession that could end up costing the region up to 12 percent of annual output over the first two years (estimates provided by ING). In addition to lost output, the banking sector would immediately need to be recapitalized. The Technical University of Munich calculates that European banks would experience an over €400 billion capital shortfall if Greece, Italy, Ireland, Portugal, and Spain left the Euro. The actual shortfall would most likely be even more severe if the Euro was completely dissolved.

On the other end of the spectrum, a fiscal union created by member countries could also stabilize the current situation and possibly be a long-term solution. A fiscal union would take form as each of the underlying governments would turn over their fiscal policymaking to a centralized European organization, and would function much like the U.S. While this could be a promising solution, the execution could prove to be extremely difficult. Europe is an extremely diverse continent with cultures that are tight-knit and self supporting. These cultures also have a long history of conflict with one another and make cooperation extremely difficult, which can be evidenced by the current debates over the crisis. The creation of a centralized fiscal authority would mean that peaceful cooperation would have to exist, but also the strong economies would have to support the weaker ones through debt relief and fiscal support. The two solutions are simplified and are examples of the two extremes; the likely solution will take a great deal of compromise from all parties and will likely lie somewhere in-between these two scenarios.

Emerging Economies

The emerging world is intriguing because of its very attractive long-term growth potential; however, the short-term poses several challenges which could prevent many investors from reaping the rewards of the growth. The long-term story has been well documented and is centered on these countries' favorable demographics and solvency when compared to the developed world. The emerging world makes up by far the majority of the population, with approximately 83 percent of the globe residing in emerging markets (based on info provided by the International Monetary Fund or IMF). Not only is the size of the population attractive, but the median age and growth of the population is much more attractive than the developed world. The size, age, and growth of a population doesn't necessarily make a region attractive, but combined with an increasing standard of living, the region can become a force when consumption begins to take precedence over saving.

As for the solvency, these economies have been developing due to a high level of capital infusion by foreign corporations. These organizations recognized the significance of a large population with extremely low wage rates, thus a boom in overseas production that has propelled prosperity, albeit into the hands of the central governments through current account surpluses and excess reserves. If this level of foreign investment continues then these economies can continue to transform their countries into internal, consumption-based economic engines.

The prospects seem bright for the developing world; however, there are few short-term issues that must be faced. First, they have not been able to de-link themselves from the consumer-driven developed economies that are currently experiencing a great deal of uncertainty (as stated in previous sections). This has put a damper on economic activity due to the export-driven nature of the emerging markets. While these countries have the financial altitude to deal with declining export demand, how long they can artificially stimulate their economies before inflation takes hold and speculative markets overheat remains to be seen.

Another point (previously made in the U.S. section) is that some developed countries are becoming more marketable in the manufacturing realm and could pose a threat to a main driver of growth. In research by Michael Aronstein (of Marketfield Asset Management), the manufacturing boom in the emerging markets is nearing the end of its fifteen year run as global corporations have slowed capital investment in these countries. Slowing capital flows combined with decreasing export demand have caused many industrial companies in the region to suffer. This could be a temporary issue if the internal consumption switch can be flipped and consumer consumption can replace declining export demand.

Political uncertainty is also a concern in the emerging world because few of the countries are free from government intervention. Economic freedom is important for growth and without it; a country cannot fully create long-term growth. The four major emerging markets Brazil, Russia, India, and China (a.k.a. BRIC) are all ranked "Mostly Unfree" (one group ahead of "Repressed") in the most recent Index of Economic Freedom published by the Heritage Foundation. No economic freedom results inefficient capital allocation and the ruling class prospering instead of labor and capital. It is important to note that not all emerging economies are the same and that those that are economically free (i.e. Singapore, Taiwan, South Korea, etc.); don't rely on commodity driven growth that destroys the country's landscape; and have favorable demographic trends will have the best path to long-term development and sustainable growth.

Highland's View

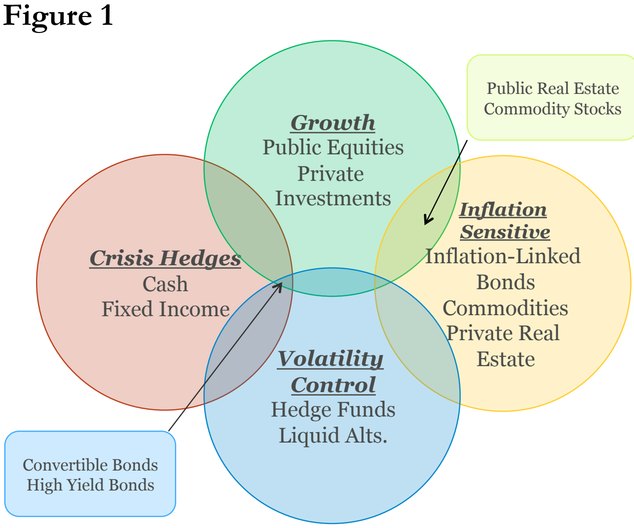
The world is at an important crossroads; one with many complicated paths that can lead to either prosperity or continued struggles. Highland fully believes that the problems faced by the U.S. and developed world can be solved, but with the caveat that the correct decisions that lead to a full recovery will not be made without mistakes made along the way. This will lead to a long, slow recovery that will feel like the world is taking one step forward followed by two steps back, leading to a great deal of uncertainty and higher volatility for capital markets.

While there are plenty of opportunities in the world, risks remain high; therefore, those that are able to manage risks properly will ultimately be rewarded going forward. This type of environment is extremely difficult for asset allocators, and those that only view the world through the lenses of modern portfolio theory will most likely suffer. That is why Highland believes a balanced portfolio approach managed by focusing on the long-term, but remaining cognizant on the present and carefully "leaning into the wind" with tactical over/under weights is the most prudent method to add value.

Portfolio Implications

Highland has long believed that portfolio construction is a difficult problem solving exercise that should not be taken lightly. Our investment philosophy is grounded in the belief that the exposures of the portfolio, not past experience, are the most important things to understand. Therefore, we examine these exposures to best understand how portfolios will react to the macro-environment. We also believe that looking at narrowly defined asset classes can lead to naive diversification and unwanted concentration. We prefer to look at the economic drivers of the investments in a portfolio to determine whether diversification is being achieved. This is something that we have done throughout our history, but we have continued to report asset allocation in the traditional asset class view (i.e. cash, fixed income, equities, etc.). **Figure 1** shows how we look at portfolio exposures and the asset classes that underpin each exposure. Going forward, Highland's view of the capital markets will be discussed with this framework in mind.

Figure 1



Crisis/Deflation Hedging Strategies

This exposure contains assets that benefit from the collapse of capital markets or by falling prices in the economy: cash and bonds. The result of the financial crisis has led to an extremely fragile financial sector. In response to the economic turmoil, global central banks have flooded the world with accommodative monetary policy. This action was to stave off the deflation and attempt to promote growth, which has produced an ultra-low interest rate environment.

The yield-to-maturity on the Barclay's Capital U.S. Aggregate Bond Index (BCAGG) finished the quarter at 2.0 percent. That is the lowest level since the index's inception (the index started in 1976). This latest low in yield has been a continuation of a trend that started in the early 1980s and has led to one the best bond markets in history. Highland sees this current yield level as a warning sign to investors. In the long-run, bond investors will earn the current yield of the bonds they own.

The current 2.0 percent yield is unlikely to fund any meaningful liability stream, and represents bubble like levels and investors should pay attention. To draw a parallel to another famous bubble (the Tech Bubble), today's yield level is roughly equivalent to paying 50 times earnings on an equity. Now we recognize that the type of investment (stock vs. bond) is different, but the idea is the same. Investors are paying too much for the anticipated cash flow and the levels we are seeing today have very little reward and are almost entirely made up of risk. We understand that financial crisis can return and widespread deflation can take hold of the world, which would cause the bond bull market to continue; however, we feel this scenario is less likely than a long-term low rate or rising rate environment, which could cause investors to accept low returns. For this reason, Highland feels an *underweight* to these types of exposures is warranted.

Growth Strategies

These types of strategies are driven by either economic growth (i.e. publicly traded equities) or by actively managing an asset to produce growth (distressed bonds, private equity, opportunistic investments, etc.). While the world has a great deal of uncertainty, corporations (largely non-financial) have been able to manage the economic storm quite well. Most publicly traded companies have been able to gain exposure to attractively growing markets (i.e. emerging markets) and have been able to use them to repair/improve their balance sheets to allow themselves room to grow going forward. Most of the fundamental data continues to show growth, albeit at a slower pace than a year ago. While this is a positive, any number of negative events could put an end to the growth and make it more difficult for equity or opportunistic investors. Valuations continue to be mixed around the globe, as the U.S. is trading close to long-term averages (i.e. normalized real P/E) and international companies are at discounts due to the European crisis. While there are opportunities in these strategies, Highland remains cautiously optimistic; therefore, we feel that holding a *target* weight to these strategies is justified.

Volatility Control Strategies

Highland utilizes many different strategies (hybrid equities, hedge funds, liquid alternatives, etc.) to control volatility in a portfolio, all of which have characteristics that are similar: variable net equity exposure, focus on intrinsic value, managers that are flexible and tactical, etc. It is important to understand that the goal of this strategy is to earn returns similar to growth strategies over the long-term, so our implementation will have equity directionality and will not have meaningful allocations to market neutral strategies. Highland believes that investors should be extremely careful in allocating to strategies that are less liquid; therefore, we believe that clients should gain exposure with liquid strategies and spend their liquidity budget on strategies that will enable them to gain higher excess returns.

Combining our assessment of growth strategies with our macro-economic view creates a view where our team is optimistic over the long-term in reference to corporate growth, but we are aware in the short-term of many possible events that could disrupt that optimism. This leads us to utilize volatility control strategies that allow our clients to capture long-term growth, but in investment strategies in which protect capital in down markets and reduce volatility over the market cycle. For these reasons, our view is an *overweight* to these strategies.

Inflation Sensitive Strategies

The vast majority of investors have an objective that requires them to be aware of inflation. Protecting or growing purchasing power is vital, whether you are an individual seeking retirement or an organization that needs to replace fixed assets in the future. The important thing to remember is that most portfolios are made up of financial assets, which are inversely related to inflation (please see our white paper "Examining Inflation and Its Effect on Investments" for a detailed examination on inflation); therefore, investors can benefit from holding a strategic allocation to investments that benefit from inflation.

Our previous research on inflation sensitive assets yielded a view that a basic basket of assets is beneficial, including public real estate, private real estate, inflation-linked bonds, and commodities. We prefer to allocate to managers that have the ability and flexibility to tactically shift among each of the asset classes, that way our clients can benefit from the assessment of professionals that know each of these markets well and will allocate to the securities that are attractively valued.

Based on the current state of the world, global monetary policy has been aggressively accommodative. Although the slow recovery has muted the effects of these policies, Highland believes that risks going forward are for elevated inflation. Whether it is rapid inflation caused by too much aggressive policy or gradual inflation due to judicial policy control, the result is that financial assets will likely suffer and inflation sensitive assets will benefit. The caveat to these scenarios is correctly forecasting the timing of the change. Highland understands that poor timing can do just as much damage as good; therefore, we feel that holding a *target* allocation is prudent.

Conclusion

Highland's view of the world going forward is a complex one. As individuals, we are optimists because deep down we want the world to succeed and do well; however, as investors, we employ a healthy level of skepticism. This allows us to look through the mountains of data that comes through our organization on a daily basis and put together an independent view of the world that looks for opportunities, but also examines how our clients could suffer setbacks. This results in portfolio construction that is focused on growing the wealth of our clients, but also is aimed at protecting them from adverse markets. As mentioned several times in this letter, we feel the current environment has prospects for growth along with many opportunities for mistakes that could result in losses. With that backdrop in mind, we feel that having a balanced portfolio over the four strategies we discussed is prudent, increasing the ability of the portfolio to participate in a multitude of possible scenarios (i.e. deflationary, inflationary, financial crisis, self-sustaining growth, oscillating markets, etc.) which could very well come to fruition.

ABOUT OUR FIRM:

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, AL. Highland was founded specifically to help develop, implement and maintain investment management programs for not-for-profit institutions. We serve a national client base of institutional investors including not-for-profit healthcare organizations, foundations, endowments, pensions, and a select group of high-net-worth individuals. As of June 30, 2012, we serve as investment consultant on approximately $16 billion in assets. With every engagement our goal is the same: to protect our clients' assets while prudently growing their portfolios over time. Please visit our website at www.highlandassoc.com to learn more about our firm.

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