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Asset Class Summaries

Fourth Quarter 2009

TIPS

TIPS performed well during the year. A better economy, reduced fears of deflation, firmer commodity prices and an increase in nominal Treasury supply drove real yields lower. The deflation fears that gripped the markets at the end of 2008 and priced TIPS' yields higher than their nominal counterparts reversed sharply during 2009. Breakevens finished the year pricing inflation much closer to their historical norms, 240 basis points for the 10-year, and 190 for the 5-year. Real yields ended the year mixed with long maturity real rates relatively unchanged, while short maturity rates fell 50-80 basis points.

Munis

Munis posted gains during 2009, as yields fell across the curve and prices rebounded considerably from their deep discounts reached in the prior year. Strong technicals drove the markets. Asset flows out of money market funds in search of higher yields found their way to the muni market, especially given the certainty of higher taxes. The BAB program alleviated supply pressures by diverting a large amount of issuance to the long-maturity taxable muni market. However, fundamentals remain challenged. The economic recovery will take time to flow through to municipalities, whose budgets remain under pressure due to the delay in tax receipts and depressed property values. Relative yield valuations of high-grade munis to Treasuries returned to their historical ranges during the year. Longer-duration and lower-quality issues fared best for the year.

Foreign Bonds

Global rates moved higher during the quarter and yield curves pressed steeper as policy rates remained extremely low and sovereign fiscal concerns loomed. Adding to the bearishness is the realization that governments will eventually end the quantitative easing programs that have kept yields artificially low. In the aftermath of Dubai, investors focused on sovereign creditworthiness, shunning the most indebted countries. Greece was downgraded to BBB, while Spain and Italy tackled debt sustainability challenges. Uncertainty should ease when countries remove support and central banks eventually raise target rates. The top performers for the year were Euro and Swiss sovereign markets, while Japan was the only developed market to decline on an unhedged basis. Japan faced deflation data and concerns a strong yen may lead to increased fiscal stimulus programs. Emerging market debt posted a record return year amid ongoing monetary accommodation and expansionary fiscal policies supporting global economic growth. Commodity exporters further benefited from the rise in commodity prices. The U.S. dollar suffered most of 2009 from lack of yield support and concerns over rapidly mounting public debt. However, it did begin to stabilize late in the year as investors crossed a threshold in terms of confidence in the growth prospects for the U.S. economy. Solid fundamentals drove emerging market currency strength, despite actions to limit currency appreciation in several markets.

High Yield

High yield bonds finished the year on a very strong note, gaining 6% for the quarter and 55% for the year. The rally was fueled by both fundamental and technical factors. Improving economic growth supported by government stimulus played a significant role in the recovery. Among technical factors, record new issuance and strong cash inflows into the sector added fuel to the rally. A combination of low interest rates and tighter spreads led to a new record of \$178 billion in issuance for 2009, with most used to strengthen balance sheets by refinancing maturing debt. Quality improved as nearly 56% of the new issuance was rated BBB and above. The strengthening balance sheets led to upgrades outpacing downgrades during the latter half of the year. The 12-month default rates showed signs of peaking in the fourth quarter near 10%. The lowest quality issues, within the higher-beta sectors such as financials, paced the year's rebound.

Fixed Income

Treasuries sold off as better economic data and the Fed's continued-dovish stance spurred a rise in yields and a steepening of the curve. In fact, Treasuries were the worst performing sovereign debt market in 2009, losing nearly 4% for the year. The spread between two-and 10-year Treasury yields reached their steepest level ever, 285 basis points on December 22nd, before ending the year at 271 basis points. The Fed's lower-for-longer rate policy anchored the short-end, while the long-end struggled under weak demand and increasing supply. TIPS performed well as inflation expectations rose on prospects of growth. The 10-year breakeven finished the year at 2.4%. The flight to risk trade amid improving economic fundamentals, record new issuance and strong cash inflows drove investment grade and high yield credit spreads significantly tighter during 2009. A major tailwind for credit was an obsession with income amid close-to-zero risk-free yields. The lowest quality issues paced the year's rebound. Agency MBS offered small gains for the quarter amid weakening technicals as the Fed's mortgage purchase program nears completion in March. The ABS and CMBS markets posted strong gains on favorable technicals, including improved demand and limited new supply.

Balanced

U.S. equity markets ended a tumultuous 2009 with strong performances in the fourth quarter as expectations for corporate earnings broadly improved and consumer spending and other economic indicators ticked mostly higher. Ongoing support from government fiscal and monetary policies also aided the financial markets. Breadth improved, and stocks in most sectors and capitalizations participated. Large caps led the way during the fourth quarter, as liquidity and quality took the spotlight, especially towards year-end, when many investors sought to maintain their gains for 2009. By the fourth quarter, the lower-quality rally



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from previous quarters lost steam as investors warmed up to companies with fewer problems. Within fixed income, Treasuries sold off as better economic data and the Fed's continued-dovish stance spurred a rise in yields and a steepening of the curve. The Fed's lower-for-longer rate policy anchored the short-end, while the long-end struggled under weak demand and increasing supply. The flight to risk trade amid improving economic fundamentals, record new issuance and strong cash inflows drove investment grade and high yield credit spreads significantly tighter during 2009. Securitized debt posted gains amid favorable technicals, including improved demand and limited new supply.

Broad Equity

U.S. equity markets ended a tumultuous 2009 with strong performances in the fourth quarter as expectations for corporate earnings broadly improved and consumer spending and other economic indicators ticked mostly higher. Ongoing support from government fiscal and monetary policies also aided the financial markets. The S&P 500 Index and the Russell 2000 Index of smaller companies advanced 6% and 4%, respectively. Information technology, healthcare and consumer discretionary were among the top performing sectors, while financials, consumer staples and industrials underperformed. Across market capitalizations, large- and mid-cap issues outperformed smaller companies. Growth stocks outperformed value stocks across all market capitalizations. The market's strong performance was quite impressive given major global headline events such as the Dubai World default scare and sovereign credit quality concerns, particularly overseas in the European countries of Ireland, Spain and Greece.

Large Value

U.S. value equities enjoyed their third consecutive positive quarter as the Russell 1000 Value Index gained 4%, ending the year up nearly 20%. Even though potential headwinds existed throughout the year, investors largely looked beyond them. Instead they focused on the positive economic and corporate signals in the market. Large caps led the way, as liquidity and quality took the spotlight, especially towards quarter-end, when many investors sought to maintain their gains for the year. Further, they stand to benefit from a weaker dollar and rapid growth in the emerging worlds. Healthcare was the top performing sector during the quarter as clarity emerged regarding reform. After lagging most of 2009, utilities and telecom posted nice gains during the fourth quarter as investors sought out their stable earnings and attractive yields. Industrials slowed a bit despite signs of improving global demand. General Electric weighed on the sector, losing 7% for the quarter as a backlog of equipment and services grew and concerns over their financial arm resurfaced. A fourth-quarter sell-off eroded some of the significant gains financial services companies generated during the second and third quarters. Concerns on further deterioration in the commercial and residential real estate markets weighed the sector down. Citigroup and Bank of America posted losses as investors reacted poorly to their equity issuance to repay TARP funds.

Large Growth

Growth stocks continued to outperform their value counterparts as they posted the strongest returns for both the quarter and the year. With the economy coming out of a recession and economic activity showing signs of acceleration, growth companies seemed to be in the strongest position to capitalize on this opportunity. The Russell 1000 Growth Index rose nearly 8% in the 4Q09, capping an advance of about 65% from the market lows in early March. The fourth quarter advance was broad-based, with all sectors posting positive returns for the period. Technology stocks were standout performers, while financial stocks lagged the overall market. Shares of information technology companies were boosted by Google, which saw its stock move sharply higher on increasing advertising revenue. Microsoft was another notable performer driven by a strong earnings report and the debut of Microsoft's Windows 7 operating system. The financial sector ended the fourth quarter in the red as Citigroup, Wells Fargo and Bank of America raised capital to repay TARP funds and began cutting ties with the government and breaking free of pay restrictions. During the quarter, stock price performance became more balanced across the quality spectrum.

Large Core

Increasing signs of a sustainable recovery in the U.S. economy helped drive markets higher for the year. Improving news on the consumer front continued to boost investor confidence. Throughout 2009, corporations were actively fortifying their balance sheets with capital raises, while at the same time reducing costs to support earnings. This year's stock market recovery was underpinned by unprecedented fiscal and monetary stimulus, both in the U.S. and globally. The S&P 500 Index climbed 26% in 2009 to end at 1,115, marking its biggest annual rally in six years. From its March 9th intraday low of 666, the S&P 500 rallied 67% into year-end. Despite this prodigious snap-back, the S&P 500 still remains 29% below the high it reached in October, 2007. Gains were broad-based with 456 stocks ending the year in the black. Taking a closer look at sector performance, nine of the 10 S&P 500 sectors were up for the quarter, with financials (-3%) the lone detractor. Information technology companies turned in the best quarterly results, up 11% as investors were lured by signs efficiency-minded companies were ready to resume investing in IT products and services. Valuations have risen but not to excessive levels, with the S&P 500's price-to-earnings ratio at 15x estimated profits over the next twelve months.



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Mid Cap

Mid-cap stocks posted solid gains during the fourth quarter of 2009, marking the third consecutive quarter of positive results for equity markets amid growing evidence of a sustained economic recovery. Growth stocks reclaimed leadership in the quarter, outperforming value 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 5%, 7% and 6%, respectively. For the year, mid-cap growth stocks outperformed mid-cap value stocks by nearly 12%. The year in review was largely a story of monetary and fiscal stimulus. While at times both controversial and costly, the programs essentially helped set a floor under stocks and sent U.S. equity markets sharply higher in one of the steepest rallies ever on Wall Street.

Small Cap Core

The Russell 2000 Index advanced 3.9% during the fourth quarter of 2009 as small cap stocks continued to rally back from the lows set back in March. Meanwhile, the Russell 2000 Value Index gained 3.6%, while the Russell 2000 Growth Index rose 4.1%. Materials, energy and consumer staples were among the top performing sectors, while financials, information technology and healthcare underperformed. Equity markets continued their march higher fueled by improved liquidity and lower volatility. On the economic front, the housing decline appeared to be bottoming, and the unemployment rate began slowing considerably during the quarter. IPOs came to the market for the first time in over a year as demand and improved liquidity contributed to this dynamic.

Small Cap Value

The fourth quarter of 2009 saw value underperform growth within the small cap segment of the market. For the quarter, the Russell 2000 Value Index advanced 3.6%, versus a 4.1% gain for the Russell 2000 Growth Index. Materials, healthcare and utilities were among the top performing sectors, while financials, information technology and consumer discretionary underperformed. The rally that began in March continued in the fourth quarter, although its momentum slowed somewhat. While returns in the quarter were not quite as robust as those seen in the second and third quarters, they were still strong and served as a nice capstone to a very good year as unprecedented global stimuli programs were seemingly successful in pulling the world economies and commercial markets out of the worst period since the 1930s.

Small Cap Growth

Small cap growth stocks rose 4% as measured by the Russell 2000 Growth Index during the fourth quarter of 2009. Materials, energy and consumer staples were among the top performing sectors, while financials, healthcare and utilities underperformed. With greater than 50% recoveries off of the dramatic lows of March, most market averages finished 2009 with their best annual gains since 2003. The quarter witnessed further improvement in financial market mechanics with a return to more normal IPO activity, a dramatic pickup in announced M&A volume, and a continued narrowing of corporate debt spreads. Investors seem to view the economic glass as half full. While the unemployment rate remained stubbornly high, trends in initial jobless claims and temporary employment suggest that the employment picture is improving. Similarly, a pickup in retail sales and online transactions in the holiday season seemed to imply an improvement in consumer confidence.

International Equity

International developed markets posted mostly positive results as the MSCI EAFE Index advanced 2% during the fourth quarter. Canada gained 5% as the central bank left interest rates at a very low 0.25% and reiterated its intention to keep it there through mid-2010 warning that favorable economic developments were being undermined by the strength of the Canadian dollar. Germany and France each gained 2%, driven by improvements in both of Europe's largest economies. The European Central Bank left interest rates unchanged at 1% amid the worst economic crisis in decades. The United Kingdom advanced 7% despite news that unemployment rose to a 15-year high leaving nearly 2.5 million workers out of work. The Bank of England also left interest rates at a historic low of 0.5%, where it has stood since March 2009. In the Pacific region, Singapore and Australia advanced 10% and 5%, respectively. Meanwhile, New Zealand ended unchanged, while Japan declined 3%. Following year-end, Japan's fragile government was dealt another blow with the resignation of their finance minister. Deputy Prime Minister Naoto Kan was named the successor and comes to the table with little fiscal experience as he faces the tough task of stimulating a struggling economy.

Emerging Markets

Emerging markets rallied in the quarter sending the MSCI EM Index up 9%, bringing the year-to-date return 79%, its best calendar year return in the index's 22-year history. Gains were strong despite news from Dubai that two of its state-owned enterprises defaulted on their debt payments. In Asia, India gained 8% as economic growth expanded by a larger-than-expected 7.9% in the third quarter, notching the swiftest pace of growth since the first quarter of 2008. China rallied 10% as economic growth broadened from public investment to consumption and private investment. Within Latin America, Brazil advanced 13% benefiting from strength in steel companies and energy-related stocks. Mexico rose 14% as economic news appeared to improve somewhat. Among EMEA countries, commodity-related stocks sent Russia up 11%. Rising commodity prices benefits Russian companies, but also allows the country to replenish its Treasury that was partially depleted to prop up the economy and currency. Turkey rose 9% as the central bank continued to slash interest rates to a new record low of 6.5%.



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International Small Cap Equity

International small cap equities continued their march forward, ending the year with a small fourth quarter gain. After a rough start during the first several months of 2009, when investors remained concerned about the breadth and depth of the global financial crisis and recession, the markets rallied strongly beginning in March, after a number of banks reported better than feared results and investors began to believe that the worst was over. Regionally, emerging markets stocks continued to lead the global rally. While both large- and small-capitalization stocks posted higher results during the quarter, large-cap international stocks generally outperformed small-cap international stocks.

Global Equity

The S&P 500 Index, the technology-heavy NASDAQ Composite and the Dow Jones Industrial Average advanced 6%, 7% and 8%, respectively. Gains were smaller within the Russell 2000 Index of small companies, which advanced 4%. International markets moved higher, with the MSCI EAFE Index ending up 2%. Among the largest European markets, France and Germany each advanced 2%. Within the Pacific region, results were mixed. Singapore and Australia advanced 10% and 5%, respectively. Meanwhile, New Zealand ended unchanged, while Japan declined 3%. Following year-end, Japan's fragile government was dealt another blow with the resignation of their finance minister. Deputy Prime Minister Naoto Kan was named the successor and comes to the table with little fiscal experience as he faces the tough task of stimulating a struggling economy. In the emerging markets, the MSCI EM ended up 9% on strength from select Latin American, Emerging Asian and EMEA (Eastern Europe, Middle East and Africa) countries.

Commodities

Commodities rebounded in the fourth quarter. Industrial metals surged, driven by rising demand for base metals from emerging economies, particularly China. Continued evidence of an economic rebound and lower inventory levels boosted oil. For the quarter, crude oil closed up over 12% and nearly 80% for the year, the biggest annual gain since 1999, but still far below its all-time high of \$145 a barrel hit in the summer of 2008. In February, oil traded for as low as \$34 a barrel, but finished the year strong at \$79 a barrel. After falling nearly 50% for the first nine months of the year, natural gas rebounded in the fourth quarter, up nearly 20%, as inventories showed that demand remained high with supply constrained. Within precious metals, gold prices benefited from a weak U.S. dollar, renewed buying interest from central banks and growing concerns over stimulus-induced inflation. Gold prices surged in the quarter, hitting an all-time high in early December of over \$1,200 an ounce. Within agriculture and livestock, abnormal weather around the world upended supply and demand fundamentals for corn, soybeans and sugar while cost-conscious consumers ate less meat.

Real Estate

Sentiment improved dramatically for domestic REITs as the year progressed, resulting in gains of 9% for the quarter and 28% for the year. The recovery of the capital markets was the important driver, allowing companies to repair balance sheets, removing solvency and liquidity concerns. The equity markets opened first followed by the unsecured debt markets. As the year progressed, the cost of capital improved materially, allowing many companies to shift into acquisition mode. Newly repaired balance sheets positioned REITs to take advantage of buying opportunities should attractively priced real estate be brought to market. Many REITs are trading significantly below replacement cost meaning a REIT can be bought for less than it costs to build its properties. From a sector standpoint, hotels and storage benefited from their short leases and their ability to respond quickly to changing economic conditions. Regional malls benefited from recapitalization and stabilization in retail sales. Apartments and offices posted gains but lagged the market as they continued to face the headwind of a jobless recovery and soft demand. Shopping centers was the only sector to post a loss for the year. The smaller retailers that occupy many centers were hit especially hard by weak consumer spending and tight bank lending conditions.

International Real Estate

International REITs rose 1% for the quarter and 43% for the year. Access to multiple sources of capital allowed REITs to repair balance sheets to conservative leverage levels. Certain markets showed signs of a rebound in property values amid declining lending rates, limited new supply and a brightening economic outlook. Asian markets led the way during 2009 as credit conditions responded well to massive stimulus efforts. Strong flows from China pushed Hong Kong 88% higher. Improvements in office market fundamentals and expectations of stronger gains in the residential markets on the back of ample liquidity and low borrowing rates further fueled this market. Improved residential sales volume drove Singapore up 78%. Japan struggled with weak investor sentiment and rising office vacancies. Australia took a breather for the quarter, though finished the year up nearly 33% driven by recapitalizations of balance sheets and improvements in economic conditions. Within Europe, the U.K. posted gains but lagged the overall market. Improvements in available credit and investor activity were offset somewhat from a constrained debt market and soft employment outlook. Continental Europe posted gains on improved sentiment and a better economic outlook. Germany staged a second half rebound on government stimulus spending and construction investment. France posted solid gains due to its somewhat insulated economy and resilient consumers, which provided some downside protection in the global recession.