Successful investing requires management of risks, and the skillful balancing of risk and expected return. In this context, risk is not a four-letter word: Investors generally get paid for bearing sensible risks, though they should not expect to get paid for bearing foolish or unnecessary risks.

Traditional Portfolios Have Performed Well Historically... The traditional stock/bond portfolio provides risk exposure to the extent that the U.S. and global economies will grow and remain stable. Historically, bearing this risk has handsomely rewarded investors. Over the past 35 years, a simple 60% U.S. stocks/40% U.S. bonds portfolio has provided an average annual return* of nearly 10%, beating inflation by almost 6 percentage points, according to Ibbotson. This solid historical track record—coupled with, perhaps, a bit of inertia in the investment market—has meant that such a portfolio, or variations thereof, including international stocks and bonds, small as well as large stocks and other twists, has remained the core portfolio for many institutions and individuals in the United States. The current level of bond yields, equity market valuation, and reasonable expectations for nominal GDP growth suggest somewhat lower returns for 60/40 portfolios looking forward. On average, we would expect these portfolios to perform well over long time horizons, and we expect that many investors will retain these traditional portfolios as their core investment holdings.

...But Today’s Investment Climate Demands a More Sophisticated Approach. The events of the past decade—and especially the past few years—have dramatically demonstrated that traditional portfolios are not a panacea for investors’ needs. The S&P 500 has provided essentially a zero return for the past decade. Corporate bonds, and especially mortgage-backed issues, were hammered during the height of the financial crisis of 2008. Safe, short-term government securities now yield less than 1%. Many firms slashed or even eliminated their dividends. Investors who were counting on steady appreciation and a predictable, growing income stream from their traditional portfolios have been bitterly disappointed over the past few years.

True, stock and bond prices have recovered, in some cases considerably, from their worst levels. Yet the events of the past several years have left investors shaken and confused. What if it happens again? What if some new source of risk—such as inflation—jumps up to hammer my portfolio? What if the fiscal problems that have plagued several European countries spread to infect other sovereign debt? Is my portfolio truly diversified—and hedged against the risks that could most damage my expected lifestyle?

Real Assets Can Provide Exposure to a More Diverse Array of Opportunities. In response to these concerns, many investors are looking beyond traditional assets to so-called “real assets,” seeking protection from some of the risks to which traditional portfolios are most vulnerable—especially inflation and market volatility. Typically, real assets are defined as those that are tangible or physical in nature, with intrinsic value because of their usefulness. Some, such as real estate and utilities, have enjoyed higher-than-average yields. Others, such as commodities, offer exposure to what will likely be the enduring economic story of the next generation: the growth of emerging economies in China, India, Brazil and elsewhere around the world.

*Average annual return is quoted before the deduction of all fees and expenses an investor would pay.
Investment in real assets is not a replacement for the traditional portfolio, but a complement to it, seeking to provide diversification, income and growth, as well as a useful diversifier against another bout of market turbulence. Following the tech bubble, for example, investors became aware of the importance of uncorrelated sources of return—and today, that need is felt even more keenly. So a more sophisticated, farsighted approach is called for—one that includes real-asset classes such as commodities, real estate, etc.

**Non-Traditional Asset Classes Offer Important Diversification**

Following the tech bubble, for example, investors became aware of the importance of uncorrelated sources of return—and today, that need is felt even more keenly. So a more sophisticated, farsighted approach is called for—one that includes real-asset classes such as commodities, real estate, etc.

**Diversification Can Generate More Attractive Risk-Adjusted Returns.** While correlations among asset classes can increase over short time periods—especially those of extreme uncertainty—longer-term history reveals that over 3-, 5-, and 10-year periods, correlations between the US equity market and real assets, such as commodities, Treasury Inflation-Protected Securities (TIPS) and real estate, have been very low. We believe that over a longer market cycle, the diversification techniques that have been used successfully by institutional investors—techniques that provide broader exposure to these uncorrelated sources of return—should continue to result in comparatively attractive risk-adjusted returns across all market conditions. In our opinion, portfolios that employ these strategies can take diversification to the next level, in response to a more complex global investment environment.

**Risk/Return Profile (10-year period ending June 30, 2010)**

Source QMA, FactSet. Returns and Standard Deviation are annualized. Please see ‘Notes to Disclosure’ for important information including risk factors and disclosures. Past performance is not a guarantee or reliable indicator of future results. Investors cannot buy or invest directly in an index.
Real Assets Have Been a Good Hedge Against Inflation. While real assets are valuable diversifiers in any economic environment, they have performed especially well in periods of high inflation.

### Real Assets Perform Well in Periods of High Inflation

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>4.8%</td>
<td>13.9%</td>
<td>-18.5%</td>
<td>4.0%</td>
<td>5.3%</td>
<td>1.3%</td>
<td>72</td>
</tr>
<tr>
<td>Normal</td>
<td>13.1%</td>
<td>10.3%</td>
<td>15.4%</td>
<td>10.2%</td>
<td>3.6%</td>
<td>3.6%</td>
<td>305</td>
</tr>
<tr>
<td>High</td>
<td>4.2%</td>
<td>0.5%</td>
<td>17.6%</td>
<td>9.9%</td>
<td>29.6%</td>
<td>9.4%</td>
<td>103</td>
</tr>
</tbody>
</table>

*Returns from January 1978-December 2009
Low inflation = < 2.00%; high inflation = > 6.00%

Source: QMA, Ibbotson Associates. Annualized returns are expressed before all fees and transaction costs. Please see ‘Notes to Disclosure’ page for important information including risk factors and disclosures. Past performance is not a guarantee or reliable indicator of future results. Investors cannot buy or invest directly in an index.

And while the near-term risk of inflation may be low, the aggressive policies put into place to ease the financial crisis make the prospect of higher inflation extremely likely in the coming years. This massive monetary and fiscal expansion, combined with potential dollar weakness and the prospects of an economic recovery, could prove to be potent inflationary triggers.

**Uncorrelated Sources of Return Help to Temper Volatility.** When the tech bubble burst, investors became more aware than ever of the importance of uncorrelated sources of return—because portfolios that consist, at least in part, of securities that move in opposite directions are typically less volatile than those comprising securities that move in the same direction. The financial crisis that unfolded in 2008 drove that lesson home even more painfully. The current high level of market uncertainty is once again underscoring the need to lessen volatility wherever possible, since diversification within and across asset classes has proven effective over the long term.

**Correlation Among Equity Classes Is High.** Correlation, a statistical measure of how two securities move in relation to each other, is measured on a scale of negative 1 to positive 1. A correlation closer to 1 represents a high correlation between securities, meaning they will usually move in the same direction. A correlation closer to negative 1 indicates a negative correlation, and the securities will usually move in opposite directions.

In the past, portfolio managers relied heavily on a blend of equity market segments as a measure of diversification. Although this is appropriate and beneficial, these segments don’t provide the maximum benefit to be derived from uncorrelated returns. The same is true of mixing domestic and international stocks: as markets become increasingly global, non-US stocks are becoming ever more closely correlated to US securities.

Because correlations are high in these equity classes, it’s critical to find uncorrelated sources of return elsewhere—especially since stocks’ collective returns have been near zero for the past decade.
Correlations Among Traditional Asset Classes Have Risen
(January 1982 thru December 2009)

Let's Take a Look at How Real Assets Serve as Diversifiers. What are some possible real-asset investment opportunities? Examples include commodities, TIPS, real estate and global infrastructure.

**Commodities.** Commodities are, to put it simply, necessities for everyday living that generally fall into three categories: energy, agriculture and metals. We need to eat and put gas into our automobiles. Various industries need metals to produce the items we rely on to maintain our standard of living, from canned goods to computers.

Commodities are a source of diversification versus equities, and within commodities, there are opportunities to further diversify. For example, oil prices usually rise during times of strong economic growth, while some metals, such as gold and silver, tend to appreciate in weak economic periods because they are viewed as safe havens.

Resource development in China, India, Brazil and other emerging markets is also spurring commodity demand: For example, overall construction in China over the past several years has been exceptionally high.

There are a number of ways to invest in commodities:

- Buy tangible physical commodities;
- Invest in a mutual fund (such as precious metals and natural resources);
- Purchase futures on specific commodities; or
- Purchase an exchange-traded fund (ETF) on specific commodities.

Source: QMA, FactSet. Please see ‘Notes to Disclosure’ page for important information including risk factors and disclosures. Past performance is not a guarantee or reliable indicator of future results. Investors cannot buy or invest directly in an index.
Gold. Among commodity classes, gold has been especially sought after by investors during periods of economic weakness, high inflation, or exceptional volatility. During times of uncertainty, gold has generally outperformed traditional assets, sometimes by a wide margin.

**Gold Often Acts as a Safe Haven in Times of Uncertainty**

<table>
<thead>
<tr>
<th>Crisis</th>
<th>Date</th>
<th>S&amp;P 500 Index</th>
<th>S&amp;P GSCI Index</th>
<th>London Fix Gold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil Embargo 1973</td>
<td>Oct ’73 to Mar ’74</td>
<td>-11.7%</td>
<td>13.8%</td>
<td>76.5%</td>
</tr>
<tr>
<td>Oil Crisis 1979</td>
<td>Nov ’78 to Dec ’80</td>
<td>59.5%</td>
<td>46.9%</td>
<td>205.0%</td>
</tr>
<tr>
<td>Market Crash 1987</td>
<td>Sep ‘87 to Nov ‘87</td>
<td>-27.9%</td>
<td>1.0%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Mexican Debt Crisis</td>
<td>Dec ’94 to Mar ’95</td>
<td>9.7%</td>
<td>-0.4%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Asian Financial Crisis</td>
<td>Jul’97 to Jun’98</td>
<td>20.6%</td>
<td>-25.8%</td>
<td>-9.2%</td>
</tr>
<tr>
<td>Long Term Capital Management</td>
<td>Sep ’98 to Dec ’98</td>
<td>21.3%</td>
<td>-17.7%</td>
<td>-2.1%</td>
</tr>
<tr>
<td>9/11</td>
<td>Sep ’01 to Dec ’01</td>
<td>10.7%</td>
<td>-11.3%</td>
<td>-5.7%</td>
</tr>
<tr>
<td>The Great Recession</td>
<td>Sep ‘08 to Mar’09</td>
<td>-30.5%</td>
<td>-52.6%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Source: QMA, Ibbotson Associates. Returns are expressed before all fees and transaction costs. Please see ‘Notes to Disclosure’ page for important information including risk factors and disclosures. Past performance is not a guarantee or reliable indicator of future results. Investors cannot buy or invest directly in an index.

TIPS. Treasury Inflation Protected Securities (TIPS) are marketable securities, issued by the US Treasury, in which principal is adjusted for inflation, with interest adjusted accordingly while the coupon stays steady. The principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. Therefore not only are interest payments protected against inflation, but so is face value of the bond, which is returned to the investor at maturity. Traditional nominal bonds offer neither of these protections.

When TIPS mature, the investor is paid the inflation-adjusted principal or original principal, whichever is greater. Since TIPS investors don’t receive less than the original principal, the original principal amount is protected against deflation as well.

TIPS pay interest semiannually at a fixed rate, which is applied to the adjusted principal. So, like the principal, interest payments rise with inflation and fall with deflation. To illustrate, assume a $1,000 US TIPS was purchased with a 3% coupon, and inflation was 10% during the first year. The face value of the TIPS would adjust upward by 10%, to $1,100. Furthermore, the coupon payment (3%), which is also based on face value, would be $33.

TIPS are generally perceived as a relatively safe investment in times of volatility, while stocks tend to do poorly in such periods. So TIPS tend to be negatively correlated to the S&P 500.

**Real Estate.** Real estate can be divided into four major categories: industrial (production, manufacturing, distribution and warehouse facilities), office (professional buildings), retail (malls, commercial strips, shopping centers, neighborhood stores and stand-alone properties), and multi-family/apartments.

Investors can enter the sector by:
Owning properties outright or in conjunction with partners; 
Investing in real estate investment trusts (REITs); or 
Investing in mutual funds, although these primarily invest in REITs.

Most institutional investors choose both direct ownership of real estate, which provides more control and eliminates the middleman, and investment in REITs, which provides more liquidity. Some REITs invest in all four types of real estate while others concentrate on just one or two. So even within a smaller category such as REITs, investors can diversify.

REITs and the S&P 500 have been a bit more correlated recently than they have been in the past, but correlation tends to work its way out over time, as the true “real estate nature” of REITs emerges.

**Global Infrastructure.** Infrastructure provides the foundation of basic services, facilities and institutions on which communities depend for growth and development. The assets underlying these investments tend to be long-lived, while producing relatively steady, secure income streams due to their lengthy, fixed-term contracts. Other attractive characteristics include high barriers to entry as well as consistent, inelastic demand for facilities.

Infrastructure includes investments in: transportation (tunnels, bridges, toll roads, railroads, airports and shipping ports); energy (utilities, power-generation plants, and oil and gas pipelines); social services (hospitals, schools and other public buildings); and communications (wireless towers and other telecom facilities).

As unemployment rates remain high and economies sputter, spending on infrastructure could increase dramatically, both in the US and globally, as a means of economic stimulus and job creation. Therefore as an asset class, infrastructure is a good diversifier from equities, which tend to move in line with the economy. And it offers growth potential, as increasingly squeezed states and municipalities sell off infrastructure assets.

As with other real-asset classes, diversity also exists within infrastructure—from domestic projects to global ones, from old-line brick-and-mortar facilities to newer telecommunications lines, and from public-works projects to private enterprises.

**An Increasingly Volatile Market Requires Exposure to a Diverse Array of Asset Classes.** In summary, while correlations can change over time, the greater the number of uncorrelated streams of returns, the better investors should be able to manage volatility within their portfolios. We believe the most effective way to cope with the current high level of volatility is to remain diversified, which requires a much more sophisticated approach than a traditional stocks/bonds/cash portfolio. A strategy that includes real assets provides exposure to a diverse array of liquid, transparent alternative asset classes, well suited to a complex and ever-changing global marketplace.

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