Update on Portfolio Allocations and Market Volatility | *September 22, 2008*

Late last week we made a change to our portfolios in which we reduced our equity exposure and eliminated our position in PIMCO Developing Local Markets. The government is currently in the process of structuring a massive bailout in which they would purchase toxic mortgage assets. We have decided that despite the proposed bailout we will be maintaining our equity underweighting for now, and also the elimination of positions in PIMCO Developing Local Markets. We will continue to assess the situation in real time, and will report back as soon as we are ready on how we will allocate that money. We also will be posting something to provide more background on the events of last week, and on our decision framework.

The reasons we are maintaining our equity underweighting follow. While the proposed bailout is a relief and significantly reduces the risk of a disaster scenario, there are still shorter-term shock risks out there. There are tens of trillions of dollars in unregulated credit default swaps that continue to lack transparency, so that's a big unknown. In general, the financial system remains fragile. So we can't confidently say that we are out of the woods.

Beyond the near-term risks to the financial system, we considered the return potential for equities in light of the possible economic damage stemming from the credit crisis and overall economic slowdown. This cycle has been unlike most others in that the real economic (as opposed to financial-market) damage, as PIMCO's El Erian put it a few months ago, is coming at the back end rather than in the beginning. The market, in our view, has been consistently behind the curve in discounting the level of economic weakness, as have we. We are still working on this and have not reached the firm conclusion that stocks aren't fully, or at least adequately, discounting the likely level of economic weakness, but based on our work so far, we believe we are somewhat more likely than not to reach this conclusion. Additionally, the massive policy solution (bailout) will itself be costly and have longer-term economic consequences, including on interest rates and the dollar, that we need to assess.

In determining our five-year equity potential return ranges, we will be taking into account the possibility that corporate earnings growth will be weaker than what we and the market had been expecting to this point, along with the possibility of higher interest rates down the road that could compress stock valuations. We haven't completed the work, but at this point, we are less confident that longer-term return potential is sufficiently high, given the risks we see, to justify a full equity weighting. We also recognize that there could be competing opportunities for our "risk capital" that may have comparable return potential to equities with lower risk, and we will be weighing those as we work to determine where we want our portfolio allocations under this new paradigm.

The rationale for eliminating PIMCO Developing Local Markets has several components. Our primary thesis for owning DLM was that it would earn a yield as good as or better than our domestic bond positions from which it was funded, and that it should benefit from the long-term secular growth of these economies, which would include the appreciation of their currencies against the dollar. This provides an additional tailwind. Additionally, the fund provides a diversification benefit because it behaves differently than other asset classes in our portfolios.

On the other hand, we also knew that DLM – because it was funded from a reduction in our core bond position – increased our exposure to recession risk (in some recession scenarios) because it would not likely perform as well as domestic high-quality bonds if the economy weakened significantly. (While DLM performed very well through July of this year, despite evidence of a global economic slowdown, we have seen this negative scenario play out over the past month or so.)

While our thesis remains mostly intact and we still like DLM over the long term, the near-term risk of significant economic weakness is much higher now, and the additional shocks to the financial system are creating a strong aversion to risk and big swings in currencies. This adds a lot of volatility to our portfolios at a time when we are already close to our 12-month loss thresholds, in the midst of an environment where our longer-term thesis is not as relevant (given the slowing global economy). For these reasons we think it makes sense to unwind these positions. In addition, we will be assessing the

longer-term impact of the government's proposed mortgage bailout on the dollar (it will very likely be negative but there will be currency winners and losers), and it is possible we will wind up wanting a specific portfolio allocation on the basis of that analysis. But at this point we aren't willing to speculate on what that might be.

Finally, we want to make the point that while the timing of our decisions wasn't great relative to the market swings last week, we don't make decisions based on daily market swings. In this environment it may seem that way to some, given that our decision to reduce equities happened amidst a large decline in stock prices. But it wasn't the decline in stock prices we were reacting to – it was our awareness that the financial system itself was virtually non-functional, and that if it continued it would have severe economic consequences. Similarly, looking ahead we obviously cannot predict the daily market swings and what that might mean to our investment portfolios. We can only issue recommended allocations based on the overall analysis of risks and return potential. Longer term, we think the specific timing of the buy-sell points will be less significant relative to the impact of the overall decision itself.

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