HIGHMARK® CAPITAL MANAGEMENT

QUARTERLY INVESTMENT OUTLOOK **APRIL 2009**

What Is Normal?

One doesn't work in the asset management business long before observing a few *black swans* and learning to never-say-never. The Financial Crisis has been atypical in so many respects, spawned by extraordinary circumstances and complexity that has been difficult to understand, even for institutional investors. We have witnessed remarkable levels of fear and startling risk premiums that emerged since the first write-offs of impaired assets held by Citibank and Merrill Lynch in October 2007. A coinciding Quant Quake suggested something was terribly amiss, slaughtering value-driven strategies even as equity indices retreated. Unwinding of leverage was a significant factor throughout this crisis. However, it was the ability to finance leverage at any cost, not simply a bet on any particular asset class, which became so critical. Policy makers pulled out all the stops, going "all-in" with global stimulus of $10 trillion and massive interest rate cuts to counteract the spiraling decline in business, consumer and investor sentiment. Loss of confidence turned a simple liquidity squeeze into an unprecedented global credit crisis that precipitated the contraction that began in September 2008.

Recessions come and go, but they are often times of wrenching transitions. Deeper recessions tend to result in greater upheaval, and this crisis surely hasn't disappointed. *What Is Normal* during such periods is not obvious. Behavioral economists observe that decision-making can become impaired during periods of severe stress, as our human nature is to take flight from risky situations. When we lose control of our circumstances, individuals may seek to assign fault, taking up figurative torches and pitchforks. Stoking populism can have adverse consequences for a nation, including increasing the cost of capital and diverting investment.

Economic models and financial theories have been refined and tested empirically over the last 40 years. Lowering interest rates, increasing liquidity, cutting taxes, rewarding success, and providing incentives all stimulate activity. Fiscal stimulus can help boost confidence, but studies show that the effects of fiscal stimulus diminish quickly unless policy changes endure, like tax cuts. This crisis has exposed certain weaknesses, but many lessons also have been learned. Events believed highly improbable are now possible.

Business and investment cycles rise and fall, but in an imperfect world, most recessions and financial accidents are simply unavoidable in the course of doing business. The U.S. economy has been subsumed by bank crises in 13% of all years since 1900. Taxpayers are frustrated with soaring budget deficits, declining home values, and the market impact on their savings. Taxpayers are also voters and elected officials should proceed with care, being sure not to abandon foundational beliefs in the interest of expedience or convenience. A lower cost of capital and better relative market efficiency is generally observed for countries that protect property ownership, maintain free markets, keep tax burdens globally competitive and minimize the cost of regulation.

The Financial Crisis of 2008 has claimed many victims. Fear itself became a significant risk, as normal risk tolerances evolved into catastrophic emotional risk aversion. The economy will feel weak for a while longer, but 2010 consensus expectations suggest significant improvement in economic growth and earnings. Prudent disciplines, such as rebalancing have been ditched and investors are questioning basic fundamental beliefs. We believe that this has ushered in exceptional opportunities for investors. The intuitive answers we crave will likely become self-evident only after some considerable period of time. Some leaders have used this crisis as an opportunity to question basic fundamental principals, but we caution that bold moves that are in conflict with history could wreak havoc for decades and hamper a return to *What Is Normal*.

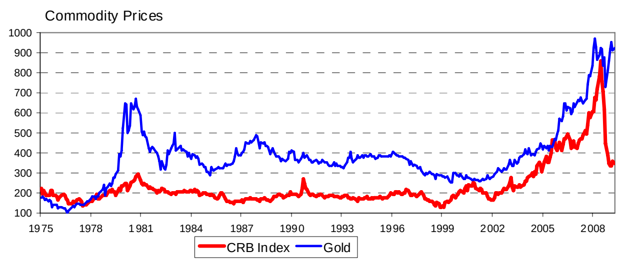
Investment Performance Review

The S&P 500 (-11.0%) kicked off 2009 with another awful quarter, but the tide seems to be changing, with March (+8.8%) rebounding 20% from the intraday low on March 9th. Financials plunged through February, which drove broader indices lower, but jumped 17.9% and was the best performing sector in March after several banks suggested the quarter was off to a strong start through February. Net interest margins are rising, thanks to a steeper yield curve that will help the banks' earn their way out of their problems if the wide spreads persist between lending rates and the cost of funds.

First quarter sector returns between Financials (-28.8%) and Technology (+4.3%) highlight the 12.6% differential between Russell 1000 Growth vs. Value indices. Large-cap stocks beat small-cap by 3.9%, while Emerging Market stocks (+1.0%) were a surprising winner, rising 14.4% in March alone. MSCI EAFE (-13.9%) lagged, as the U.S. trade weighted dollar firmed another +4.9%.

Treasuries fell to an unsustainably low yield of 2% last December, but rose to 3.1% by the end of February as deep recession fears began to moderate. Even an announced Treasury purchase of $300 billion or 25% of expected issuance couldn't reverse the trend. The Fed is hoping to drive mortgage rates lower toward 4.5%. Credit spreads tightened during the first quarter, but rising Treasury yields held the Barclays Aggregate Bond Index to just 0.1% return.

Commodity prices rose +1.6% during the quarter, based on the CRB Index. Gold tracked commodity prices through October, but have diverged significantly since then. We believe the downside risk to gold prices could be substantial if economic concerns fade and given the divergence from commodities.



Source: HighMark Capital and Thomson Datastream

In Plain Sight

Something went terribly wrong globally in 2008 for so many companies to have faltered and equity indices to have retreated so dramatically. Systematic breakdowns are rare, but may be necessary to correct imbalances. They also can be the result of policy changes in taxes or regulation. This Financial Crisis has been atypical in many respects, spawned by the "*perfect storm*" of extraordinary and complex circumstances. Calls for increased regulation extend to lapses in oversight that, for example, didn't expose Ponzi schemes such as Madoff Investment Securities or Stanford Group.

The case against Bernie Madoff, who was running the world's largest hedge fund, is particularly troubling. Little effort was required to determine that his spectacular returns didn't correlate with any known investment or strategy, but generated monthly returns that were rarely negative. CBOE options traders never saw his business, but his positions should have been extensive. The Boston Whistleblower, Harry Markopolous, spoke at a recent conference we attended. His story documents surprising systemic enforcement failures following his first SEC complaint in May 2000. Adequately enforced securities and exchange regulations is critical to the normal functioning of global capital markets.

The Troubled Asset Relief Program (TARP) was a creative idea designed to provide government loans to banks that needed to shore up their balance sheets and increase lending after accounting losses----no strings attached. Taxpayer backlash over bonuses has tripped up Congress and the Administration. The resulting policy shift toward exerting operating control over TARP loan recipients has unnerved them, including General Motors. Several banks apparently want to repay government loans as soon as possible, or have already done so, but Congress has indicated surprise and doesn't seem to understand recipient's concern. Effectiveness of future government bail-outs and programs, including the Public-Private Investment Fund (PPIF), may be impeded by fears of intervention. JP Morgan has said that they will not participate in PPIF as buyers or sellers. Insurance companies that were seeking TARP funds have now balked. Treasury believes it is premature to repay taxpayer loans, but many companies' actions indicate that they no longer want the government's help.

As a result of this crisis, we expect to see consolidation of all securities-related regulatory functions into one "homeland" financial regulator. We believe that the SEC, CFTC, FINRA, and NYSE have responsibilities that overlap and should be consolidated for greater effectiveness. The U.S. Treasury, OCC, FDIC, and Federal Reserve also share responsibilities. Hedge funds have grown rapidly in number and assets without much oversight, tapping leverage multiples with only investors to judge their capabilities. Hedge funds with U.S. investors could end up being regulated. Credit Default Swaps (CDS) are one of the most significant new financial instruments engineered in the last two decades. Swaps remain loosely regulated, yet are complex, highly customized, often leveraged, and very lucrative to originate. DTCC Deriv/SERV established a catalog of swaps, which if available last fall, might have increased transparency. We think that CDS positions should have been subject to similar regulatory oversight as listed futures and options, and that responsibility could have been delegated to the CFTC.

Mark-to-Market Coming of Age

Fair value accounting rules on mark-to-market pricing were recently changed. Accounting write-offs on asset-backed securities coincided with wide bid-ask spreads, credit illiquidity, and extraordinary gaps between intrinsic values vs. market prices. We have advocated sensible rule changes to minimize mark-to-market accounting volatility and supported suspension of the Uptick Rule, which facilitated stock manipulation and naked short selling. Many assumptions used in the analysis for these 2007 rule changes were flawed, in our opinion, and could have exposed Bear Stearns and Lehman Brothers to unscrupulous manipulation as a result of changes.

"Mark-to-Fantasy" is a catchy phrase for criticism of changes to fair value accounting rules. However, investors should not abandon their faith in corporate accounting. Regulatory oversight of public accounting tightened meaningfully with the passage of Sarbanes-Oxley in 2003. Corporate officers are subject to personal liability and should continue to conservatively recognize impairments. Changes to mark-to-market accounting rules should improve liquidity and reduce financial statement volatility, while providing greater usefulness and comparability.

Economic and Capital Market Outlook

Fear of the unknown seems to be the greatest threat to global economic expansion today. There is a great deal of uncertainty, so any attempt to forecast the economy or capital market returns is even more challenging than is usually the case. Risks to the economy seem to be moderating, although economic conditions still feel uncertain and imbalances remain. Difficult economic conditions remain the leading cause for earnings growth caution, although we believe all that needs to be done has been done to re-accelerate economic activity and restore normal functioning of capital markets. Patience will be rewarded, but fiscal and monetary support will take time to work, as history teaches.

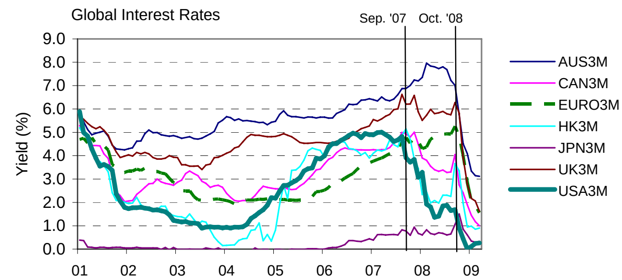
Earnings recovery from the -24.6% drop in 2008 will be key to a sustained stock market recovery. We are encouraged by initial first quarter earnings reports that seem somewhat better than expected. S&P 500 consensus expectations suggest a decline of -10% in 2009, followed by a rebound of 27% in 2010. This is almost as *abnormal* as the contrast between the -90% collapse in Financial sector earnings during 2008 versus the 1% increase in non-financial earnings. Steepening global yield curves coupled with market share gains across fewer competitors should help banks improve their profit margins materially. The gravest earnings concerns are Energy and Materials, which are both expected to decline over -50% in 2009.

Various statistics suggest recovery may already be gaining traction. While there are still a great many risks to economic activity, three sequential increases in the ISM survey are meaningful. Weekly unemployment claims have receded, but continuing claims will likely increase until unemployment benefit extensions are fully reflected. With pending home sales rising, more buyers are taking advantage of fiscal stimulus incentives and improved housing affordability. Home sales volume has increased and the first sequential price increase in over a year was observed in February. Lower mortgage rates allow consumers to refinance their homes, while the decline in oil and natural gas prices has freed up disposable income. Oil prices declined from $147 to $50, adding $700 billion of purchasing power.

Economic	*2006*	*2007*	*2008*	***2009e***	***2010e***
U.S. GDP (Real)	2.8	2.0	1.1	**-1.5**	**1.8**
Earnings Growth	15.3	-1.6	-23.6	**-8.3**	**25.0**
CPI Inflation	3.2	2.9	-0.1	**0.0**	**1.5**
Unemployment	4.6	4.6	7.2	**9.0**	**8.0**
Fed Funds Target	5.3	4.3	0.3	**0.3**	**1.5**
Treasury Notes-10y	4.7	4.0	2.3	**3.5**	**4.5**

Source: HighMark Capital estimates & Thomson Datastream

If recent indications of improving economic conditions are prescient, the fiscal stimulus was probably wasted and the Federal Reserve may need to raise rates higher than would otherwise be necessary without the $787 billion fiscal stimulus. In 2007, the federal budget deficit shrank to 1.3% of GDP, but the deficit for fiscal 2009 is expected to soar to 10%, according to Bloomberg consensus. Risks of higher inflation are increasing while debt issuance is also expected to dramatically increase for Treasuries, corporate bonds, and municipals. Deficits this high will cause crowding-out of investment capital, resulting in higher cost of capital and interest rates.



Source: HighMark Capital Management and Thomson Datastream

The credit crisis and recession will likely precipitate many changes. We expect higher business and personal income taxes will be required to fund increased spending. The Federal deficit is estimated to exceed $1.3 trillion for FY2010 vs. $163 billion in FY2007 due to new spending in the proposed budget legislation. If the tax code becomes more progressive, tax revenues will become increasingly cyclical, intensifying deficits during economic slowdowns. Proposed cap-and-trade carbon tax estimates exceed $1 trillion. That is a tax of $2,600 per capita or $10,400 per family of four that is expected to offset universal health care spending. Higher taxes increase inflation for consumers as it factors into the cost of doing business. We think that increasing deficits, inflation, tax hikes and a higher cost of capital suggest that *normal* trend growth rates of 2.5-2.7% are at risk.

Rights and Consistency

America has benefited from strict adherence to free-market principals, individual property rights, Capitalism, Federalism, and the rule-of-law that have withstood the test of time. These values and beliefs have propelled our economy for decades, encouraging entrepreneurship, innovation, and rewarding of success. No other country benefits from these forces as we do, so we must resist those who might blame our core beliefs for recent global challenges. Abandoning certain core beliefs may appear popular, but could have adverse consequences that undermine productivity and the comfortable standard of living we've enjoyed. History is riddled with examples of countries that faltered and suffered the consequences. Russia and Venezuela recently paid dearly for nationalizations. On the other hand, Latin American, Eastern European, and Asian countries have displayed impressive economic performance, as they embraced Capitalism, free markets, and property rights. Innovations open up new frontiers, but may also expose unforeseen risks, including gaps in regulatory oversight. We think that attention should focus on consistency and enforcement of existing regulations, as well as anticipating effects of change.

That is not a just government, nor is property secure under it, where the property which a man has in his personal safety and personal liberty, is violated by arbitrary seizures of one class of citizens for the service of the rest….A just security to property is not afforded by that government, under which unequal taxes oppress one species of property and reward another species.

If the United States mean to obtain or deserve the full praise due to wise and just governments, they will equally respect the rights of property, and the property in rights: they will rival the government that most sacredly guards the former; and by repelling its example in violating the latter, will make themselves a pattern to that and all other governments.

--- James Madison, **Property**, March 1792

Policy shifts can increase concern if there is the potential for adverse impact on efforts to attract investment and keep the cost of capital low in a globalized world. A change in policy and legislative trends appealing to voter frustrations suggests to us a turning point that could cause us concern should it gain momentum.

Investment Conclusions

America has historically adapted to confront many challenges. The recent equity rally was triggered by indications economic conditions seem to be stabilizing and the credit crisis of 2008 seems to be moderating in response to new monetary tools. We think pent-up potential demand can bolster growth in the second half of 2009. Concerns linger about housing weakness, rising savings rates, and the resilience of secular emerging market trends. Other lurking concerns that lie ahead include increasing federal budget deficits, risk of higher inflation, and the difficulty in eventually unwinding monetary stimulus. Increased debt issuance, including issuance deferred last year, will likely strain debt markets. We expect long-term yields to rise, even if inflation remains contained.

Recessions are often periods of recalibration and transition. Some changes will be useful and productive, while others may be undesirable. Increasing taxes and regulation have never been effective ways to resolve our imbalances. However, we do support increased regulatory consistency and more effective enforcement, including rationalizing overlapping government agencies to improve their effectiveness.

Differential returns between stocks and bonds can cause the asset mix to drift. An equity market decline of -40% causes a 60% equity exposure in a balanced account to drop to just 46%. Simulation of a severe bear market followed by recovery demonstrates the value of portfolio rebalancing vs. a drifting asset mix, A rebalanced portfolio's drawdown is greater, but wins over the long-run.. Wall Street tends to run away when stocks are on sale, but even well into recovery, rebalancing is the surest way to benefit from dramatic swings in returns.

Capital markets tend to anticipate economic recovery by six-to-nine months. We believe that exceptional bargains have emerged as a consequence of behavioral biases, providing opportunities for active investors, including overweighting equities and high-yield bonds. Given the massive stimulus in the pipeline, we believe economic conditions and earnings should trough in mid-2009. Productivity and profit margins are generally stronger after a recession as costs have been rationalized and weak competitors donate market share to stronger survivors. Investment and business cycles will come and go, but we will inevitably return to *What Is Normal*.

David Goerz, SVP - Chief Investment Officer

http://commentary.highmarkfunds.com