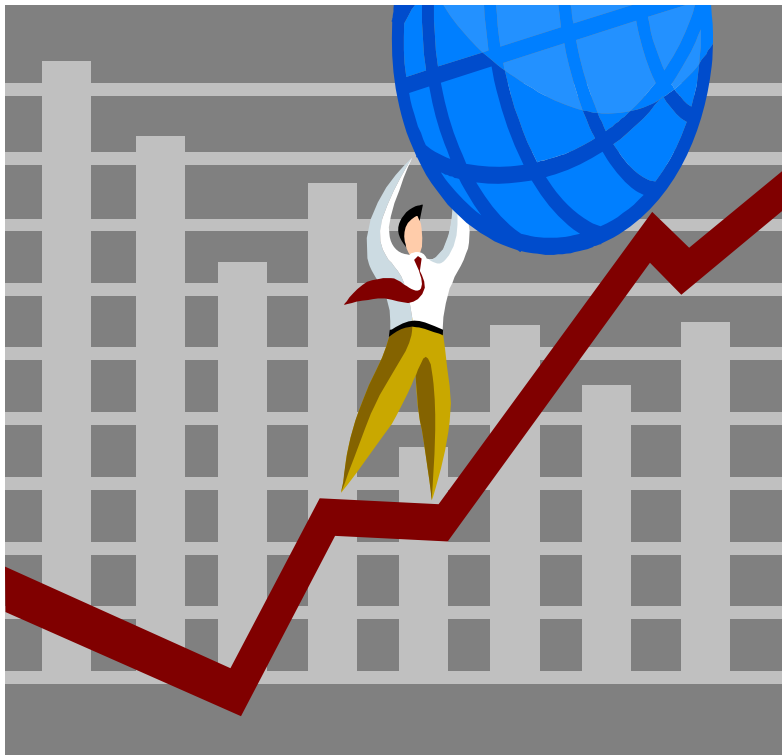


2008 Outlook & Investment Strategy



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Review of 2007 Outlook and Strategy

Prediction	Result
<p><i>On balance, 2007 should be a reasonably good year. <u>But risks are increasing.</u></i></p>	<p><i>Oh yes, <u>risks did increase.</u> Difficult to call it a good year. However, stocks and bonds did beat cash, so not a poor year.</i></p>
<ul style="list-style-type: none"> ▪ Baseline Outlook. US stocks should enjoy average to good returns and outperform bonds for the fifth straight year. Positives include at least a pause in the interest rate cycle, with possibly one or two rate cuts in the second half. High LBO activity should also add support to equities. Bonds returns will continue to be tepid, but bonds may exhibit short-term rallies as expected housing/growth weakness tests the markets. ▪ Risk Assessment. <u>The risks to the economy and the stock market are greater than they were in 2006. We are in the late stage of the economic cycle, which tends to have higher than average volatility (although a 1995-style soft landing is possible).</u> Our internal forecast of a recession over the next year is higher than the consensus forecast of a 27% chance. In addition, market sentiment indicates that risk appetite is high (which typically is not a positive for future returns). ▪ Maintain a neutral stance on Stocks vs Bonds. Stock valuations are reasonable, especially considering their balance sheets. Other positives are low interest rates, falling inflation, and continued merger, LBOs and share buy-back activity. However, profit margins are receding, and recession risks are rising. ▪ Underweight US Small Cap and Value Stocks. Small cap stock valuations are not as attractive versus large cap stocks as they have been. Plus, in a late-stage economy, we prefer to be neutral-to-light in these segments, especially as liquidity is extracted. ▪ Overweight Foreign Denominated Bonds, TIPS, and maintain reasonable Gold Share exposure. We continue to believe in the long-run dollar weakness thesis due to US deficit position. In addition, gold share exposure should provide insurance given a crisis. ▪ Underweight Commodities. As the world economy, at least temporarily, slows to a more restrained growth rate, so should demand for commodities. The shape of the futures' curve (contango) will continue to weigh negatively on commodities' total return. ▪ Overweight Japanese Small Cap. Japanese small caps are one of the cheapest asset classes in the world, period. And they posted anemic returns last year, thereby increasing their attractiveness. 	<ul style="list-style-type: none"> ▪ Stocks were reasonably healthy and retained a 2% edge over bonds going into December 27 but finished the year with a nosedive. Meanwhile the Fed cut interest rates three times, and bonds exhibited short-term rallies with demonstrable housing and growth weakness testing the markets. ▪ Our elevated recession forecast was non-consensus and spot on. Our forecast in December 2006 was a 45% probability of recession (versus the consensus of 27%). The consensus is now forecasting close to a 40% probability. Market sentiment was indeed too positive, and all the major sentiment gauges are significantly less positive now. ▪ Keeping a moderated stock stance in 2007 was the right call. Despite reasonable stock valuations, fears of a recession (and its associated effect on the credit markets), caused stocks to be largely range-bound. ▪ Our underweight of value and small cap stocks was our best (and most significant) call in 2007. US large cap value was down 3% and US small cap was down 5% while US small cap value was down 11% in 2007. ▪ Diversifying our bond exposure was very helpful in 2007, especially to non-dollar assets. The dollar fell 9% against major currencies, and gold was up 31%. ▪ Oil & Gas based commodities surprised to the upside in 2007. The futures' curve did indeed weigh negatively on commodity returns to the tune of minus 14%. ▪ This call was either early or wrong. Our bet is that it was early. Japanese small caps remain the deepest value investment in the world. Positively, Japan provided diversification on some of the worst days of the year.

Sources: US Large Cap Value is Dimensional US Large Cap Value, US Small Cap is Dimensional US Micro Cap, US Small Cap Value is Dimensional US Small Cap Value, Gold is ETF GLD. Oil & Gas Based commodities is Goldman Sachs, GSCI Index. Consensus recession probability is Wall Street Journal. Currency data is Trade Weighted Dollar from Federal Reserve.

2008 Outlook and Strategy: *More Sizzle! Or More Steak?*

Like 2007, 2008 will be another challenging year. If there is a surprise, it will be that when the dust finally settles, we will find ourselves in an environment where risk is priced soberly, and a base will have been laid for the bull market's next wave.

Baseline Outlook. Despite the “song of the sirens” luring investors to sell all their risk assets, we believe that by the end of next year stocks will have fared better than bonds, cash or commodities. We also believe that cash will have outperformed Treasury bonds, while commodities could be whipsawed by slower growth. Since we believe that stocks’ final destination next year will be a good one, we are loathe to lighten-up on them today, even though their first stop might be at a place less appealing.

Risk Assessment. Fear has choked financial markets. Through coordinated actions, central banks are aggressively seeking to create liquidity in money markets and, more importantly, to raise investor confidence. If investor fear can be abated in the first quarter, 2008 may be a real bounce-back year. But if investor fear can't be broken, we will experience intermediate-term volatility. Although negatives are easy to see here, we believe that in the end it will be more profitable to ride out the storm rather than hide under the bed. Positives include:

- Central banks are not napping. They are using both conventional methods like interest rate reductions and unconventional methods like the Term Auction Facility to re-liquify banks.
- Reasonable stock valuations,
- De-coupling of world growth (still reasonably strong) from US growth (faltering),
- Weak dollar finally may be paying off,
- Negative sentiment is high (and is typically a contrarian indicator), meaning that a recession, while not entirely priced-in, could already be significantly priced-in.

One caveat: if a populist candidate is elected President – market participants will not be rewarded.

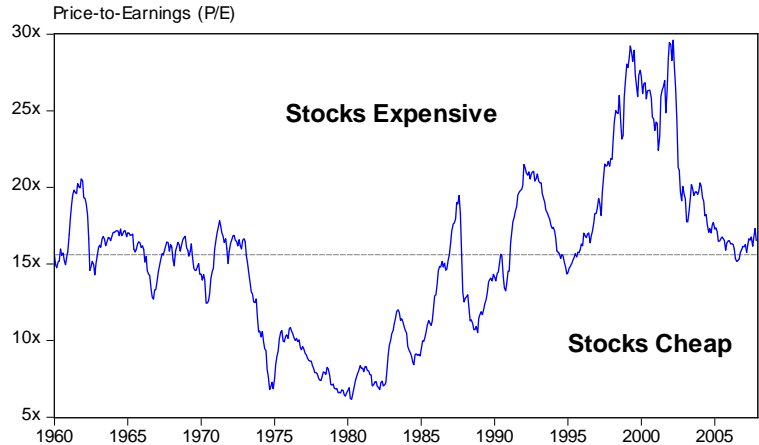
Strategy.

- **Stocks vs Bonds: Neutral (at least for first part of year).** Stock valuations are attractive versus bonds, but short-term risks lead us to a neutral initial posture. However, should central banks be successful in returning confidence to capital markets, we would look to add exposure and possibly over-weight stocks.
- **Value vs Growth: Underweight Value.** Like last year, we continue to see value stocks underperforming growth stocks in 2008 due to flight to quality and relative cheap growth valuations. Also when growth outperforms value, it's usually for a period of about two years. But from a trading standpoint, we will be long-term buyers of value if it shows considerable weakness.
- **Large vs Small: Underweight Small.** Very similar rationale to overweighting growth: relative valuations, flight to quality, as well as small caps' multi-year outperformance over large cap stocks.
- **US vs International: Neutral.** A weak dollar has finally made US companies competitive overseas while valuations of international stocks have become relatively more expensive (as they have become “must-own” investments). Nevertheless, greater growth outside of US keeps us at neutral. We will, however, still overweight Japanese small caps as they continue to be one of the cheapest asset classes in the world.
- **Commodities: Modestly underweight.** Commodities have run up significantly and are likely to giveback some return in a slower growth environment. We look to build exposure on weakness. Commodity futures curve is now flat-to-positive, which is a marginal plus.
- **Bonds: Continue Short-Duration – Add to Emerging Market exposure.** Bonds, especially longer-duration bonds, are “priced for perfection” or more accurately “priced for doomsday”. Big sell-off possible if growth resumes and/or inflation continues uptrend. Local market debt in select emerging markets should outperform international developed markets due to their strong currencies and financial conditions.

Valuation of Stocks vs Bonds: Stocks Look better, And...

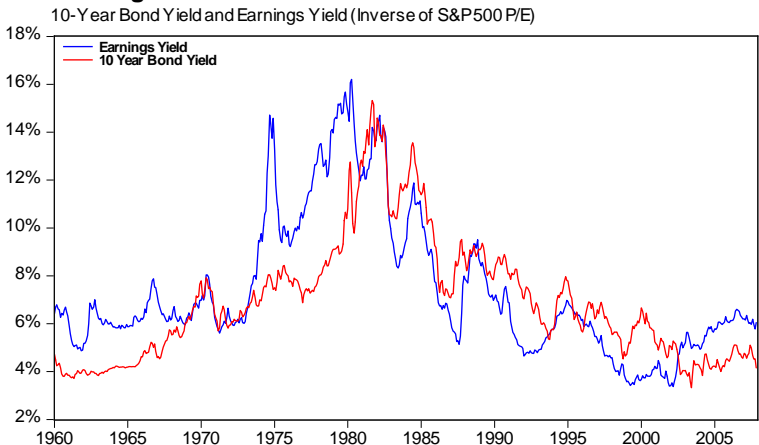
Stocks look fairly valued on an absolute basis versus history, hovering at average multi-decade valuation multiples. When taking inflation into account, stock valuations also look reasonable. Excluding banks, balance sheets are very healthy.

S&P 500 Price-to-Earnings (P/E)



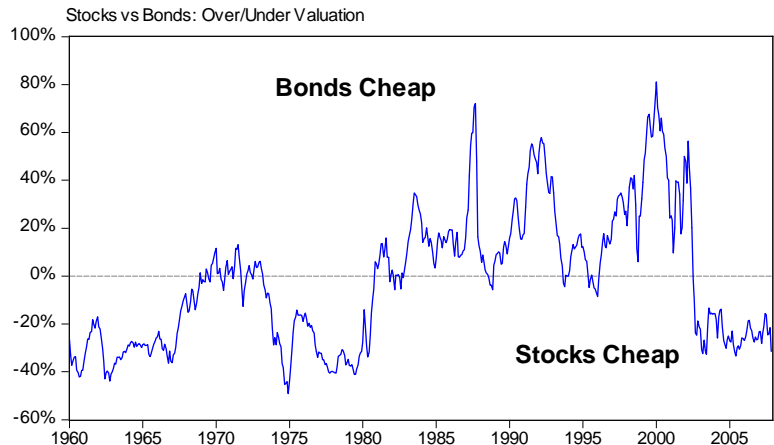
Yields are significantly higher in the stock market than they are in the bond market, suggestive of better returns in the stock market.

Earnings Yield vs 10-Year Bond Yield



Bottom line: Stocks continue to look attractive versus bonds based on the historical relationship between bond and earnings yields. Indeed, they are cheaper on this valuation technique than they have been for the past two decades.

Stock Valuation Model



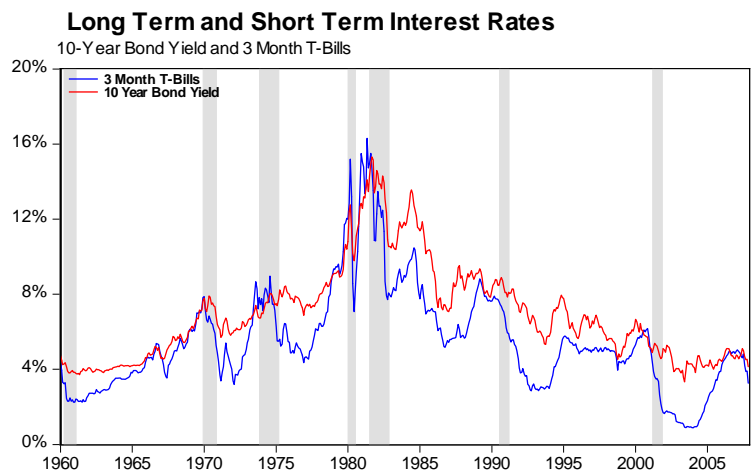
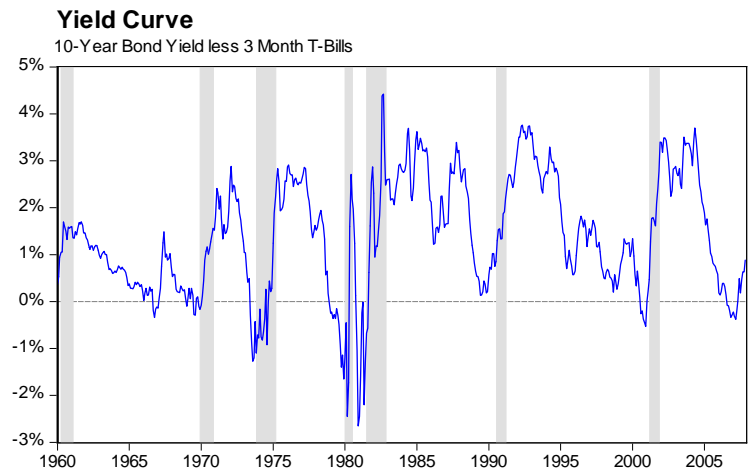
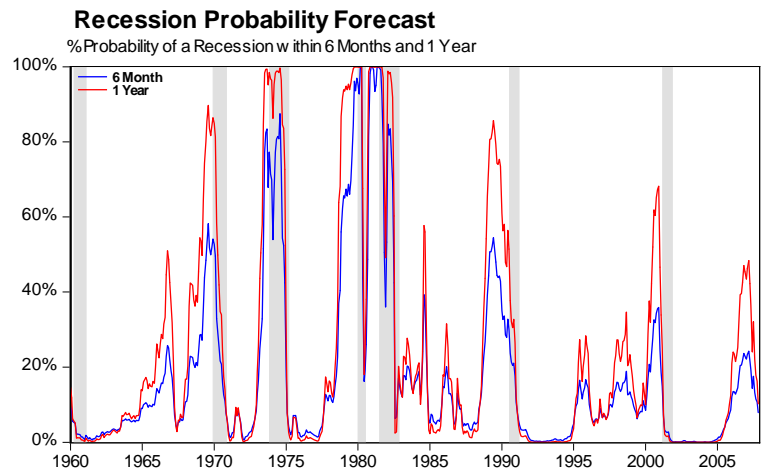
Notes: P/E data is calculated using Professor Robert Shiller (Yale) data and WCM estimates. Earnings are trailing operating earnings. 10-Year bond yield data is from Federal Reserve.

Risk of Recession: Elevated, But Is It Priced-In?

Everyone agrees: the risk of a recession is high. But has a recession already been priced-in to the market? Or are we already in a recession? At the end of 2006, we estimated the 12 month probability of recession at 45% (significantly higher than the 27% consensus). The consensus is now 38%.

While the risk of recession is high, the shape of the yield curve indicates there might be hope, as it is no longer inverted (where short-term rates are higher than long-term rates). An inverted curve is a strong predictor of a weakening economy and of recessions.

And interest rates are going back down. The trillion dollar question: is cheap money going to save the day as it has historically? While we may indeed go into recession, aggressively lower interest rates may make it short-lived.

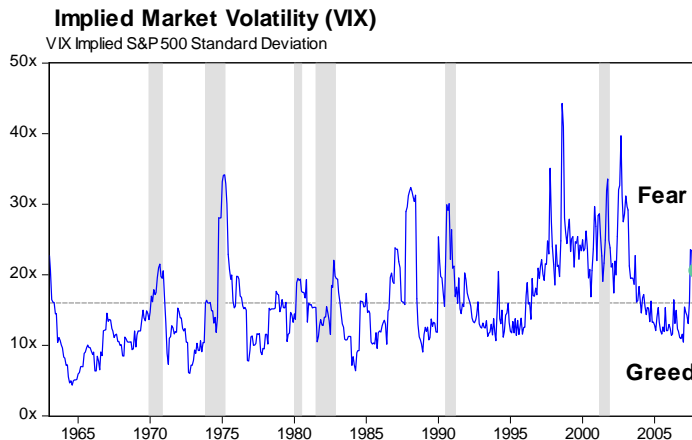


Notes: Shaded areas are NBER defined recessions. "Recession Probability Forecast Prediction" based on Federal Reserve Staff Working Paper by Matthew Wright, The Yield Curve and Predicting Recessions, 2006. The model is a probit regression (Model B) based on the yield curve and the level of the short term interest rates. The consensus recession probability is from WSJ December 2007 Survey.

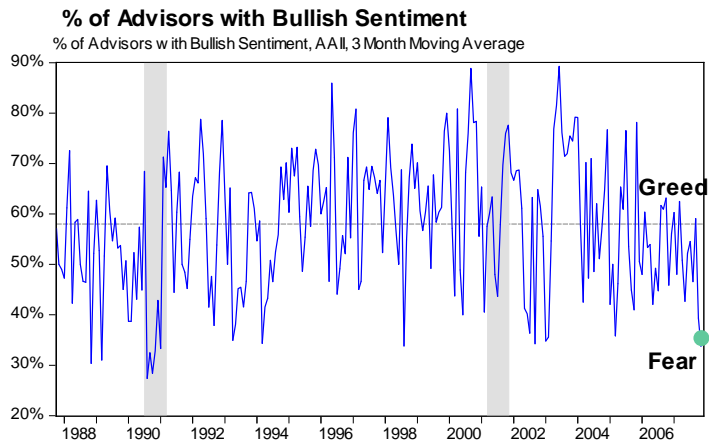
Investor Sentiment: Has it Turned Too Negative?

Investors have gone from overly sanguine regarding risk to very scared.

Implied volatility, or the market's pricing of risk, has gone from multi-decade lows to a level well above average.



Investor sentiment has also gone from ebullient to very bearish. On average, it is more profitable to invest when optimism is running low and fear is high.



Credit spreads are at average historical levels. While sentiment is negative, the fact that credit spreads are fairly narrow indicates that people are not quite jumping out their windows.



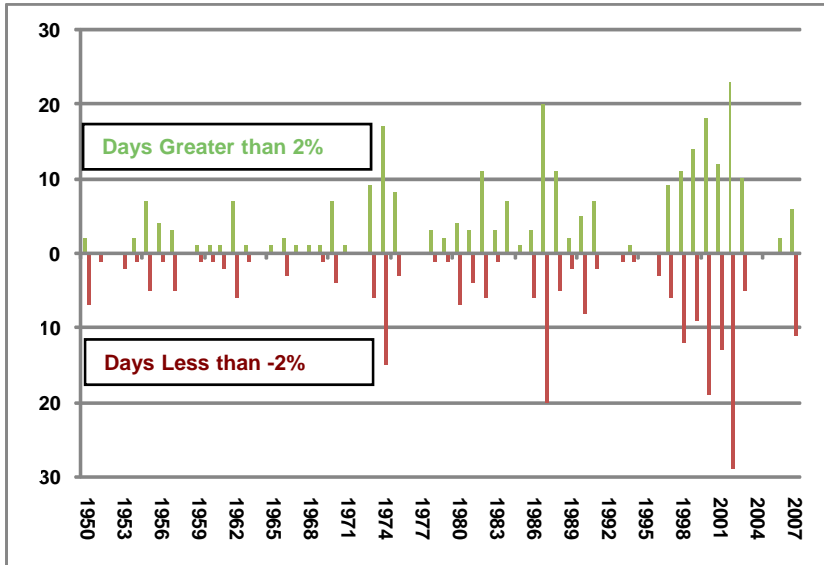
Notes: Shaded areas are NBER defined recessions. VIX data is WCM estimated from 1960 to 1989, and utilizes actual data thereafter. AAIL is American Association of Individual Investors, and % of Advisors with Bullish Sentiment is calculated as % Bullish / (%Bullish + % Bearish).

Volatility and Diversifiers: Volatility to Remain High

Volatility picked up dramatically in 2007: Get used to it! It has been uncharacteristically low the past few years. Historically, the ratio of up-days to down-days is roughly 1:1, so you need to take the good with the bad. Keep your helmets on.

Historical Volatility in the S&P 500

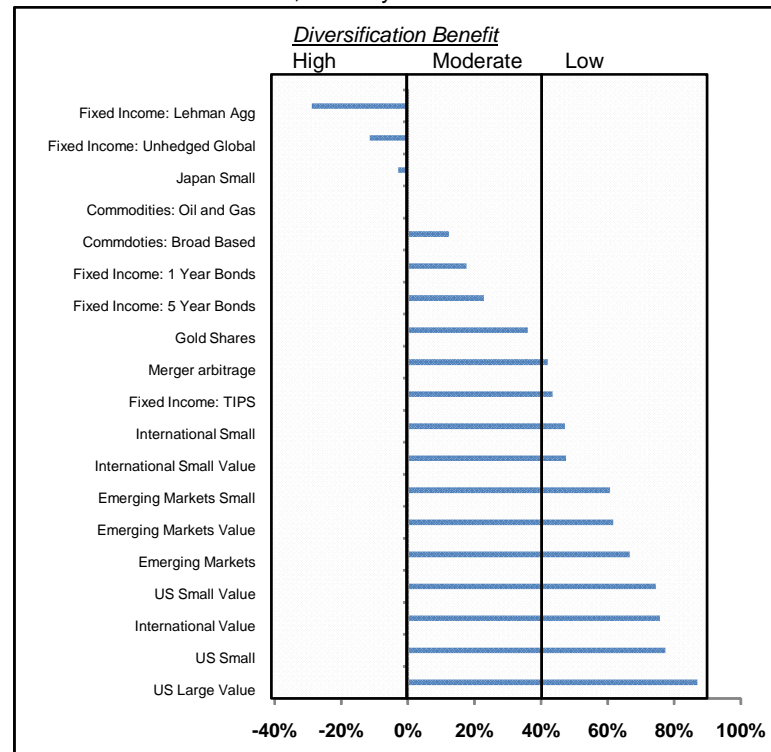
Number of days greater than 2% and less than -2%



Finding “less-correlated” assets is key to diversifying and dissipating volatility. Correlations are elevated versus history, but there are diversifying pockets of opportunity such as Commodities and International Small Cap (especially Japan).

Recent Diversifying Power of Different Asset Classes

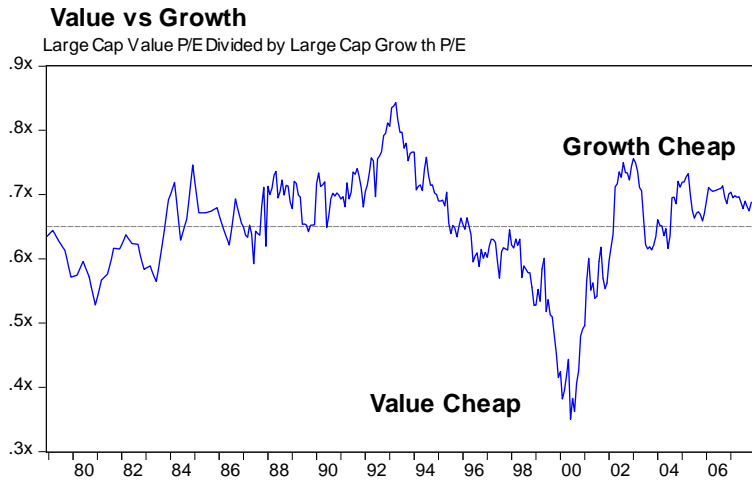
Correlation to the S&P 500, January 2006 - December 2007



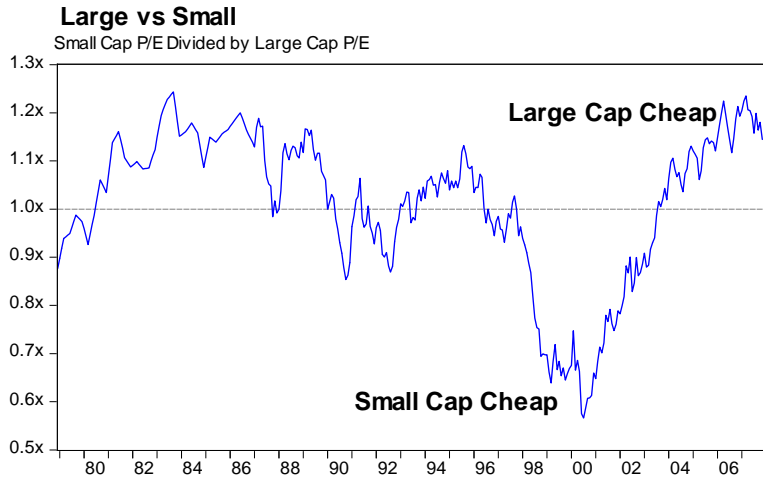
Source: Standard and Poors daily return data utilized for the Historical Volatility chart. For the Recent Diversifying Power of Different Asset Classes, please refer to Appendix for source of data.

US Equity Style Valuations: Large Growth Still Looks Good

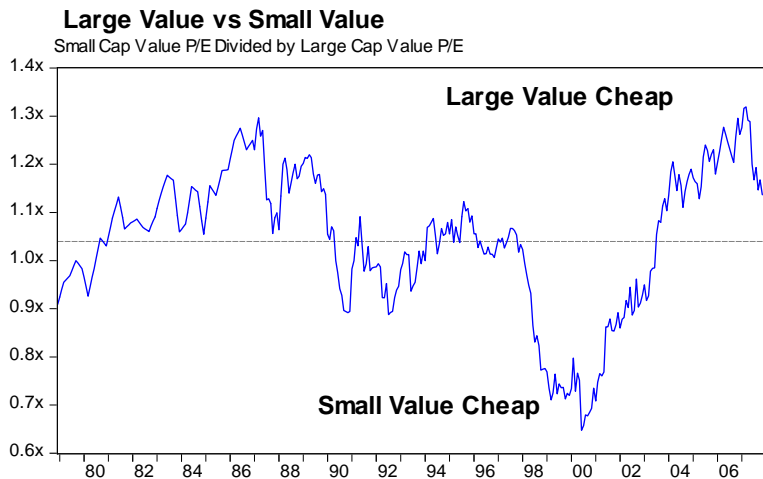
Large Cap Growth looks cheap compared to Large Cap Value on a valuation basis.



Large Caps look relatively cheap vs Small Cap Stocks on a valuation basis.



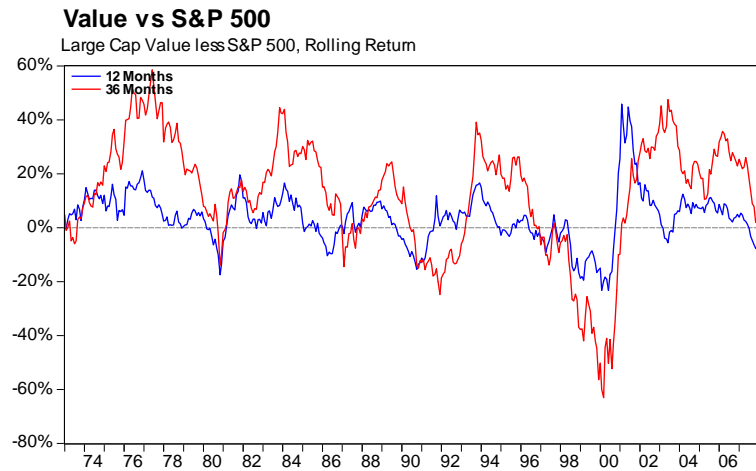
Large Cap Value is still cheaper than Small Cap Value, but the trend seems to be reversing (quickly).



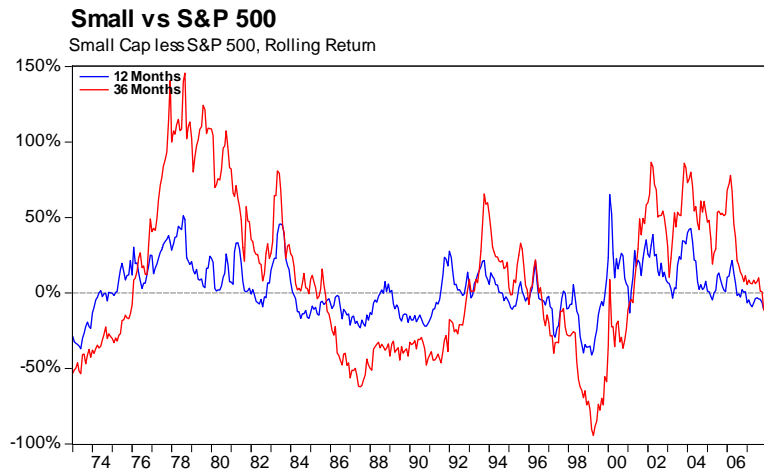
Notes: Source Frank Russell. P/E data excludes negative earnings. Large is Russell 1000 and Small is Russell 2000. Value and Growth are the value and growth variants of the Russell 1000 and Russell 2000.

Trailing Performance: The S&P 500 Looks Attractive

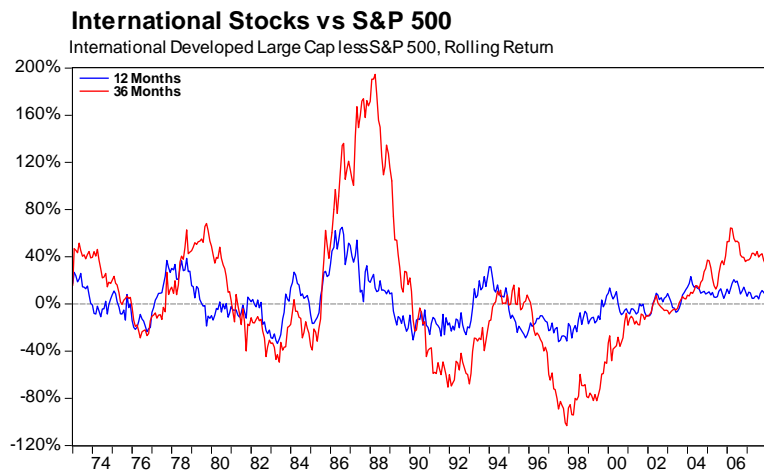
Large Cap Value has been on a tear for much of the last decade. Its momentum seems to be waning.



Small Cap has also been soundly beating the S&P 500. Its momentum also has slowed considerably.



International stocks have also handily outperformed the S&P 500.....

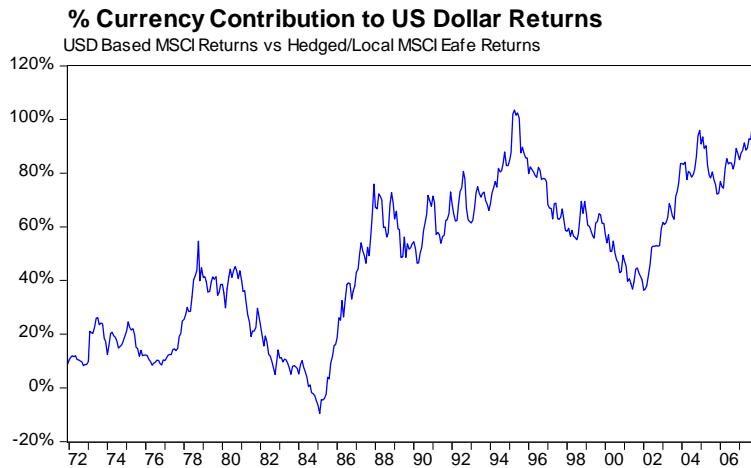


Notes: Value is Dimensional US Large Cap Value, Small is Dimensional US Micro Cap, and International Stocks is MSCI EAFE. For periods prior to the fund inception dates, WCM estimates based on index data from Dimensional Fund Advisors and MSCI.

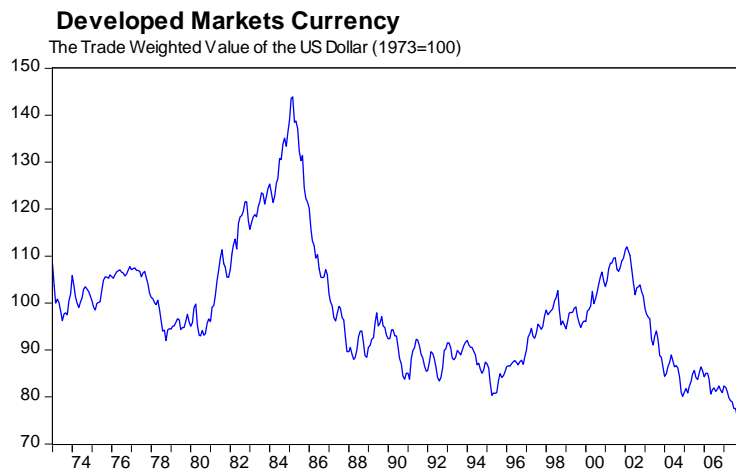
Currency: Longer-Term Down, Short-Term Oversold?

A weakening dollar has contributed significantly to US investor foreign investment returns.

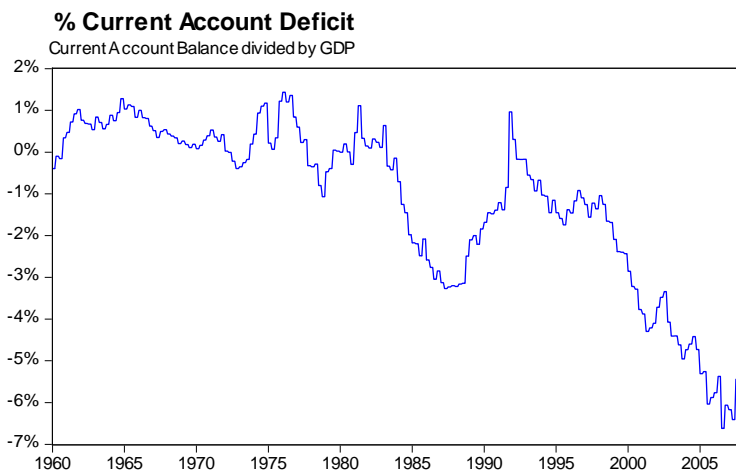
Since 1970, currency has augmented US investor returns in international markets by a full 100%.



The dollar is in a long-term decline against its major partners, and we believe that this trend will continue in the long-run. However, we believe the rate of its decline will slow, or possibly temporarily reverse, in 2008.



A short-term bottom? The current account may be showing signs of a temporary bottom. Dollar weakness and resilient global growth, has finally led to an increase in exports (which typically is a positive for the dollar).



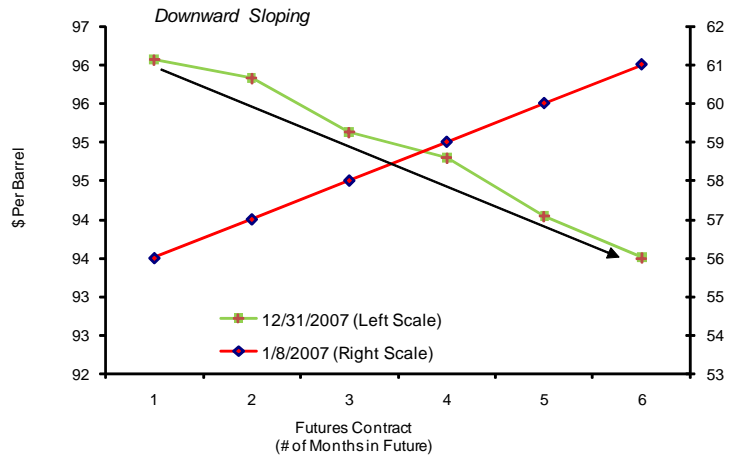
Notes: Current account and currency data is from Federal Reserve. Currency contribution is from MSCI, and is calculated as the cumulative difference between the unhedged and hedged MSCI EAFE Index. The importance of the current account is well described in "The Unsustainable US Current Account Position Revisited" by Maurice Obstfeld (UC Berkeley) and Kenneth Rogoff (Harvard) 2005.

Oil & Gas Based Commodities: Ciao Contango?

The futures curves for oil are now downward-sloping and no longer in sharp “contango” (where forward curves are upward sloping). If oil prices do not change a cent, this implies investors will be rewarded with approximately a 3% additional annualized return in 2008.

Crude Oil Futures

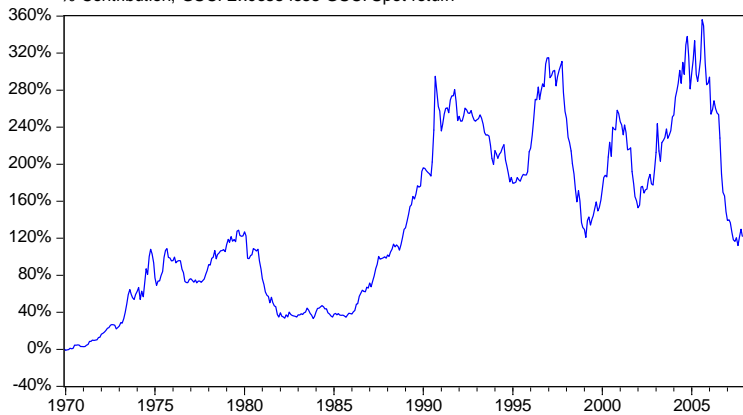
Current Futures Curve vs Beginning of Year Curve



Historically, the shape of the futures curve for commodities (i.e., downward sloping) has been a key driver of total commodity returns. We are back to downward sloping, and should be gaining incremental returns as a result.

The Contribution of the Roll Yield to Commodity Returns

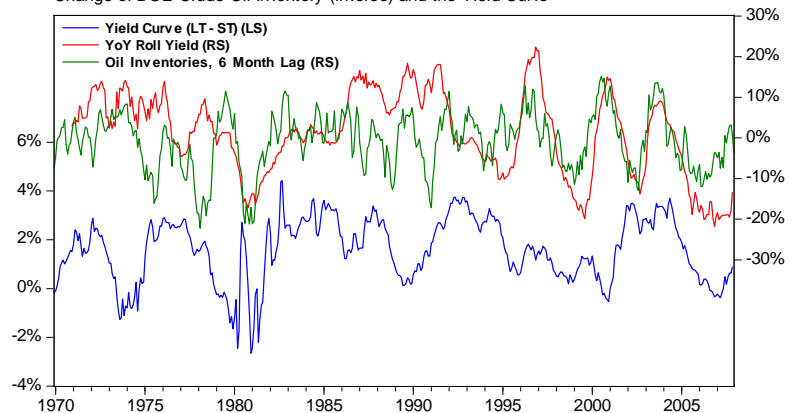
% Contribution, GSCI Excess less GSCI Spot return



And the market fundamentals suggest that the futures curve could be downward sloping over the intermediate window.

Key Drivers of the Roll Yield (YoY Change)

Change of DOE Crude Oil Inventory (Inverse) and the Yield Curve



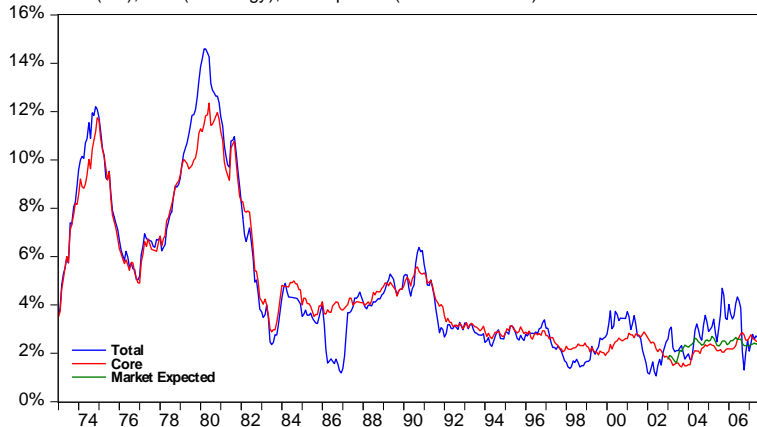
Notes: Crude Oil Futures data is from NYMEX, Contribution of the Roll Yield is from Goldman Sachs. Oil Inventory data is from Energy Information Agency, and Yield Curve source data is Federal Reserve.

Inflation: Under Control?

Inflationary pressures appear to be building, as commodity price increases and a weaker dollar are working through the economy.

Inflation

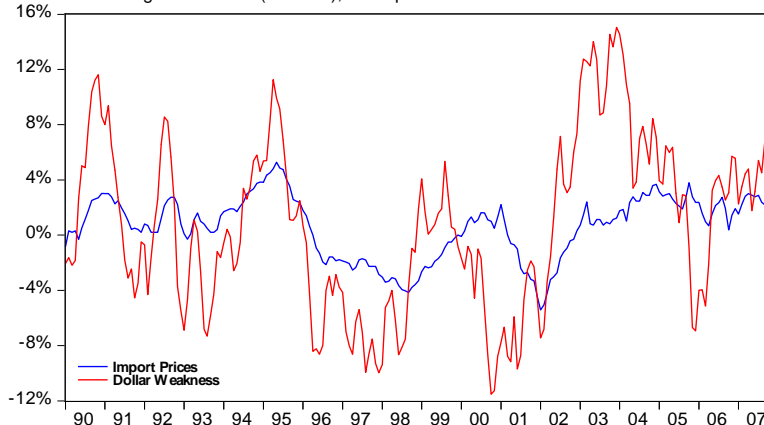
Total (CPI), Core (ex Energy), and Expected (TIPS Break-even)



A weak dollar is a key risk to the inflation picture. A weaker dollar means higher prices for imports, and hence higher inflation. The Fed (and investors) will be keeping a close eye on the dollar and its link to inflation.

The Dollar and Imported Inflation

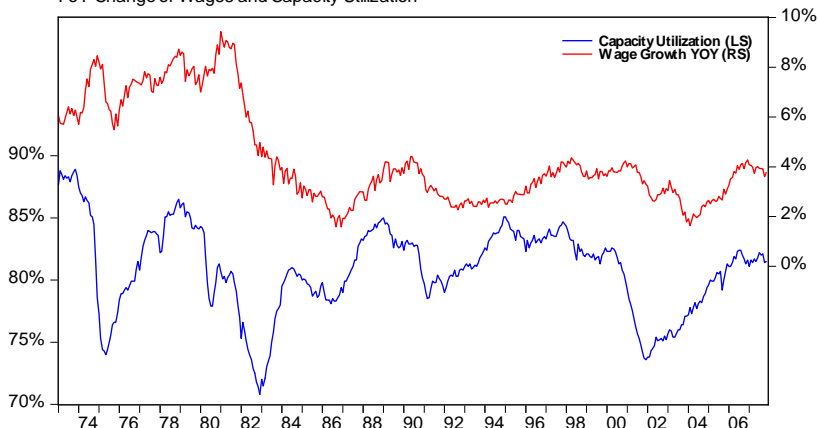
YoY Change of US Dollar (Inverted), and Import Inflation Ex Petroleum



Other key factors driving inflation are not moderating, suggesting inflation may not be contained. Capacity utilization (or opposite of the “slack” in manufacturing plants) is modestly tight based on recent and historical levels, and is trending up.

Wages and Capacity Utilization

YoY Change of Wages and Capacity Utilization



Notes: Data is from Federal Reserve. To understand what drives inflation, and the specific role of capacity utilization in inflation, the following is a good reference: “U.S. Inflation Dynamics: What Drives Them Over Different Frequencies?” Ravi Balakrishnan and Sam Ouliaris, International Monetary Fund, 2006.

Disclaimer

Past performance is not a guide to future performance and the value of investments and the income derived from those investments can go down as well as up. Future returns are not guaranteed and a loss of principal may occur.

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