

When Popular Theories Go Wrong

The Financial Crisis of 2008 took the world to the brink of economic collapse. In the aftermath, many theories have emerged attempting to assign probable cause to the unprecedented decline in global prosperity. We won't know for some time who got it "right" for the "right" reasons and who was just lucky. It does appear that the calamitous predictions of early 2009 seem misguided, given the strength of the global recovery and the normalization of capital markets observed. The recession and dramatic shift in risk aversion now appear cyclical and associated with the lack of liquidity and availability of credit. In this respect, the recession was most similar to the 1980 Credit Crisis, triggered when President Carter imposed the Credit Control Act. However, it took more than a simple stroke of the pen to reverse the decline in available credit after the *Perfect Storm* of regulatory enforcement failures, misguided policy changes, financial complexity, and adverse cyclical influences.

This business cycle may have to run its course until we can, with reasonable certainty, tally up the significance of each potential cause of the Financial Crisis. The effectiveness of certain stimulus measures offers the best evidence of the significant causes, in our opinion. Monetary stimulus, including guarantees and interest rate cuts, has been unmistakably more effective than fiscal stimulus. Thus, we see a different recovery path than conventional wisdom suggests---one that is stronger and broader than is usual following a recession. This is partially attributable to unusually high productivity and robust profit margins which are occurring alongside the forces of steep inventory destocking, record low interest rates, extraordinary credit support, shortfalls in new housing construction, net export deficit, deferred capital investment, and pent-up consumer demand.

While we missed calling for the catastrophic collapse of confidence and seizing up of credit markets last fall, we have maintained that the global policy response was indeed sufficiently massive and correctly focused to ensure a high probability of success in restoring liquidity and the normal functioning of capital markets. The recovery in business, consumer, and investor confidence, as well as economic conditions, has been stronger than we had hoped for six months ago. The recovery in equity prices emerged so quickly that many investors have not even re-balanced. Is the recent equity rally the beginning of a new bull market or already nearing a peak?

We believe that suggesting the business and investment cycle will be different this time is a perilous supposition. Some even question the basic beliefs and values that have served us well for over 200 years to justify radically different policies. In *Think Without Boundaries* (September 2009), we questioned the *New Normal* hypothesis of much lower potential growth and the "subordination of the equity risk premium." These unpleasant presumptions don't have to be America's destiny, and since popularized in spring 2009, are deeply in the hole already.

We believe that an important 2010 theme will be global re-synchronization of economic activity, with growth and inflation exceeding consensus forecasts in at least North America and Emerging Markets. This would necessitate monetary and interest rate tightening sooner in these regions and to a greater extent next year than expected. Conditions favor stocks outperforming bonds rather than the "subordination of the equity risk premium", as popularized by the *New Normal* hypothesis.

Something has to give when distinct asset classes seem to be discounting different economic scenarios, as we have observed. It is unusual for gold, commodities, currencies, Treasuries, and equities to indicate such diverging scenarios. *When Popular Theories Go Wrong*, investors in crowded trades can get hurt when trends reverse and many head for the exit simultaneously. Below, we discuss various popular theories and suggest what we believe will be important for investors.

Our Recommended Tactical Asset Allocation

In aggregate, HighMark's Asset Allocation Committee (AAC) tactical recommendations have taken advantage of many opportunities this year, adding 1.3% vs. our 60% equity/35% bond benchmark through November. Similarly, HighMark's Growth & Income Allocation Fund (A-share), run with wider ranges and tactical breadth, outperformed by 3.8% vs. a similar benchmark this year net of expenses, following a challenging year in 2008.

The global economy is expanding once again and even appears to be accelerating. The pace of recovery has exceeded even our expectations, as U.S. annualized real growth increased 2.2% in the third quarter, suggesting an end to the recession in June.

Our long-term U.S. potential growth expectation remains at 2.7-3.0%, but in the intermediate term, further upside is expected, if cyclical fundamentals continue to improve. Companies began to pre-announce upside earnings surprises in March that sparked an equity rebound. The S&P 500 has returned 67% since it troughed March 6th.

HighMark's AAC recommends a 6% overweight to equities with a recently added 1% allocation to REITS vs. an -8% underweight to bonds. The +24.1% S&P 500 return through November is closing in on our January 2009 year-end target of 1150. On the other hand, it has been a difficult year for bond investors, as 10-year Treasury yields have risen from 2.2% to 3.2%, returning -4.7%. With Treasury bill yields near 0%, investors have experienced a loss in real purchasing power versus inflation. Bonds could come under further pressure in 2011, with yields rising beyond our January 2009 year-end 10-year Treasury target of 3.7%. A rotation this year from overweighting growth by 5% to favoring value stocks (1%) has been timely. Two tilts that haven't worked out as well include our modest tilt favoring small-cap stocks (S&P 500 – Russell 2000 = 6.4%) and overweighting U.S. stocks by 3% relative to international stocks (S&P 500 – MSCI EAFE = -6.5%), mostly attributable to weakness in the U.S. dollar (-9.4%). U.S. equities vs. EAFE had a 6.1% return advantage from which we benefited in 2008. Tilts to overweight high-yield bonds (+51.7%) and emerging markets (+72.2%) also added value this year.

Economic Outlook

America has durable competitive advantages and has proven its resilience once again. It never pays to assume her to be fragile, inflexible, and unable to adapt to business cycles that ebb and flow. Massive monetary stimulus that leveraged unconventional and creative ingenuity in developing a few new policy tools, coupled with slashing global interest rates, has overcome an unprecedented credit crisis. Already high U.S. productivity provides exceptional conditions for a sustained period of above average growth in emerging markets and North America. In many respects the causes of the decline and the reaction of policymakers were unlike any that we have ever experienced. We expect that the global recovery will also will be unique, leading to unprecedented resynchronized global growth.

Economic Forecasts	2006	2007	2008	2009e	2010e	2011e
U.S. GDP (Real)	2.8	2.0	1.1	-0.9	2.5	3.0
Earnings Growth	15.3	-1.6	-27.9	0.4	25.0	22.6
CPI Inflation	2.1	4.4	-0.2	1.0	1.8	2.5
Unemployment	4.6	4.6	7.2	10.1	9.4	8.5
Fed Funds Target	5.25	4.25	0.25	0.25	2.00	3.25
Treasury Notes-10y	4.71	4.03	2.25	3.50	4.50	4.75

Source: HighMark Capital estimates and Thomson Datastream

We have observed a strong acceleration in many leading business and consumer sentiment indicators, particularly the recent Institute of Supply Management survey. The pronounced "V" is now showing up in mid-cycle

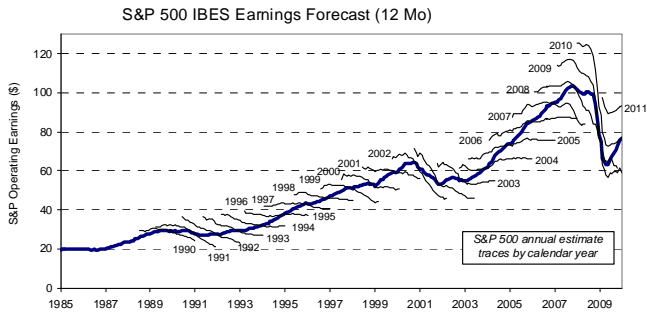
variables, including industrial production, capacity utilization, and retail sales. The global recovery scenario is increasingly accepted and the debate has now shifted to whether the big "V" is sustainable. The likelihood is increasing that economic growth may exceed 2.7% potential growth earlier than expected. If 2010 growth estimates continue trending toward 4%, then this recovery should be sustainable.

Popular Theory #1: Skepticism about the sustainability of the expansion is our first popular theory deserving a closer look. Economic variables haven't been this volatile in at least 30 years. Right on cue, eight months after injection of significant monetary stimulus, the U.S. economy is growing again. The refinancing of consumer and corporate debt at low interest rate levels will result in lower interest expense for years to come. So-called toxic assets are now trending toward their intrinsic value, bolstering balance sheets. It appears the correction may have overcompensated, but now the real economy is gaining traction. The natural state is for earnings to grow and economies to expand, subject to the ebb and flow of the business cycle.

A recent ISI Group survey of CFO's identified capital and business reinvestment as their top priority for uses of cash, followed by lowering debt and acquisitions. We believe that the following macroeconomic forces have aligned and have the potential to reinforce one another.

1. Inventory restocking
2. Net exports rebounding
3. Deferred capital investment accelerating
4. Depressed housing starts normalizing
5. High productivity from slack in labor and production
6. Household net worth increase of \$5 trillion since March
7. Emerging market decoupling
8. Low interest rates, plus government liquidity

Popular Theory #2: Consensus earnings forecasts finally have caught up to our more optimistic view, bucking popular theories of corporate demise that could lead investors astray. Accelerating earnings growth has driven up cash flow, benefiting from strong productivity and high profit margins. Thomson reported that 72% of companies in Q2 beat earnings estimates. Few expected that this remarkable performance could be smashed by a record 79% ratio of positive earnings surprises in Q3, which was the highest rate since 1983, even as estimates rose into quarter-end. The change in Q3 earnings versus last year was expected to decline by -25%, but instead declined by just -13.8%. Earnings for 2009 were expected to decline -11.5% in July, but now are expected to be roughly flat. Upside guidance on future earnings and revenues was also welcome and helps explain the further bounce in equities. *When Popular Theories Go Wrong*, investors can lose out, remaining on the sidelines while hoping for a better buying opportunity. The upward trend in earnings estimates could eventually lift S&P 500 earnings to \$100. Assigning a 15X earnings multiple suggests an upside on the S&P 500 Index of 1,500, plus dividends.

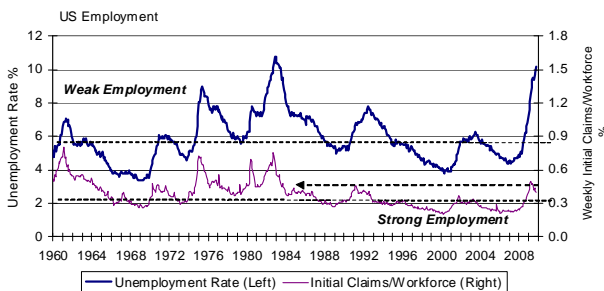


Earnings	2011e	2010e	2009e	2008	2007	2006
HighMark	22.6%	25.0%	0.4%	-27.9%	-1.6%	15.6%
Consensus	21.8%	29.4%	-4.0%	-27.9%	-1.6%	15.6%
HighMark	\$ 95.00	\$ 77.50	\$ 62.00	\$ 61.74	\$ 85.62	\$ 87.04
Consensus	\$ 93.39	\$ 76.67	\$ 59.27	\$ 61.74	\$ 85.62	\$ 87.04
Financials	53.7%	79.4%	185.7%	-127.2%	-2.1%	21.8%
Non-Financials	19.6%	19.4%	-22.0%	7.4%	3.2%	12.4%

Source: HighMark Capital estimates and Thomson Datastream

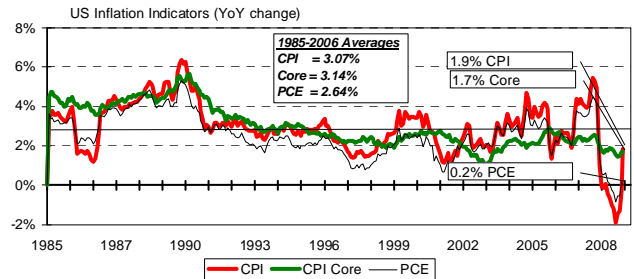
Stronger retail sales and industrial production support increasing revenues. Shuttering of weaker competitors has also provided a market share grab among the survivors. This should support a compelling equity return from current levels. Valuation multiples of trailing earnings, depressed by accounting write-offs, may give comfort to the *New Normal* crowd, but we expect greater equity upside, fueled by strong sequential earnings growth of 22-25% through 2011. Listed corporations have more cash and less leverage in aggregate than anytime in the last two decades. Empirical Research Partners calculated as of Q3 that net cash has increased to 9% of assets, while the long-term debt/assets ratio has declined from 18% to 13% since the early 1990s. The equity rally since March may have further to run supported by earnings, book and dividend valuations.

Popular Theory #3: Another popular theory is that slack in labor (unemployment) and production (capacity utilization) will keep inflation low for quite awhile. Weekly initial claims on unemployment have dropped below 500K for the first time in 18 months, while capacity utilization troughed in June, industrial production troughed in July, and housing prices troughed in January. The peak in initial claims observed tends to be reached several months ahead of unemployment rate decline. We tend to recover from deep recessions faster (ex: 1975, 1983, and 1993). We don't think that slack will remain underutilized for long if housing starts recover and broader economic themes evolve, as we expect.



Source: HighMark Capital and Thomson Datastream

The Fed has defended the notion that sufficient labor and production slack exists to keep inflation expectations low. However, inflation typically trends toward 2.5-3.0%. Reversion to a normal inflation rate has already been observed as wages continue to climb, supported by a legislated minimum wage increase, and commodity prices rise. The CRB Index has climbed 32%, cocoa prices have doubled, and oil prices have jumped 76% in 2009. With Q4/2008 deflation rolling off and visibly stronger economic activity, we expect inflation expectations to rise. Inflation may remain contained, but not sufficiently low enough to justify 3.5% Treasury yields. Inflation shows no sign of easing from the 2.7% CPI increase so far this year. Slack is necessary, but not sufficient, to keep inflation contained.



Source: HighMark Capital and Thomson Datastream

Popular Theory #4: A fourth popular theory is that the Fed won't raise rates in the foreseeable future. We believe that investors should distinguish between the Fed's perception that current conditions "warrant exceptionally low levels of the federal funds rate for an extended period" and the inference that rates will not increase in 2010. We believe that the Fed will begin to raise rates sooner than expected, possibly by spring 2010. It is unlikely that the Fed can justify endangering price stability, if inflation is increasing and the economy is growing at or better than its potential rate. Indeed, interest rates of 2% would still be exceptionally low if inflation was over 2%. Policy interest rates typically average inflation plus 1.5%. The risk of igniting inflation is increasingly treacherous if the Fed is forced to hike interest rates more aggressively than a steady ¼% pace.

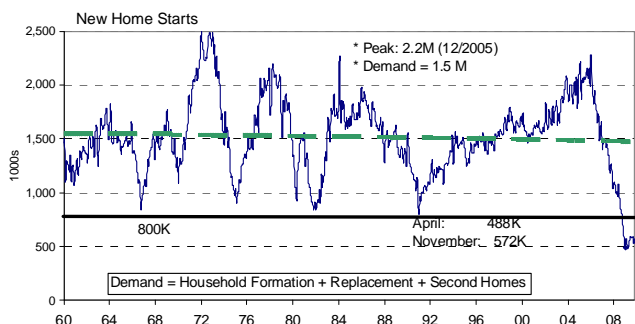
Stanford University economics professor John Taylor recently suggested that rates should rise materially before mid-2010. At the Atlanta Fed conference ("Systemic Risk and the Role of Government," May 12, 2009), Taylor argued that the policy guidance rule, bearing his name, already implied a fed funds rate of +0.5%. Inflation has increased significantly since May. There are various interpretations of what the Taylor Rule prescribes. In May, he specifically attacked a reported Fed staff estimate of an "optimal" Taylor rate of -5% as having "both the sign and the decimal point wrong."

Popular Theory #5: Many complex programs initiated to reverse the effects of the Credit Crisis seem to be misunderstood. Stabilizing initiatives were designed to increase liquidity and access to credit, but limit taxpayers cost by being structured as preferred equity, loans and guarantees. Troubled asset prices have recovered

significantly, as liquidity in these securities and the housing market have improved, adding to bank earnings and bolstering capital ratios. The \$700 billion Troubled Asset Relief Program (TARP) is winding down with loans to the largest banks having been repaid, following strong earnings. In the process, it has become a lightning rod for Main Street fury. Preferred equity settlements by Wells Fargo and Citibank boosted repayments to \$185 billion or 75% of the \$245 billion loaned to banks. Treasury has collected \$17.6 billion from 5% annual dividends, plus warrant settlements to date.

Balances of all programs, except for TALF, are now shrinking due to waning demand. These programs may still yield a profit for taxpayers, but losses are expected from AIG, mortgage agencies, and the automakers. Recent proposals to redirect repaid liabilities and recognized gains into new spending programs or a second stimulus are misguided and troubling. It demonstrates either a dim understanding of these programs by legislators or a wily attempt to mislead taxpayers to justify further giveaways.

Popular Theory #6: Most observers believe the housing market is still overstocked and can't recover until the overhang is extinguished. We have suggested that housing inventories are localized, thus high inventories in overbuilt markets won't limit housing starts where new jobs are available. Housing starts would help bring down unemployment. Given we have been building fewer homes than the 1.6 million units needed to meet demographic demand, we expect housing starts should more than double from the current annual level of 574K. If so, housing should bolster both jobs and the economy.



Source: HighMark Capital and Thomson Datastream

Popular Theory #7: Investors expect further U.S. dollar weakness, but currency fundamentals are supportive of the dollar, with the exception of interest rate differentials. We expect the Fed to move before Europe and Japan. Consensus forecasts from *The Economist* for 2009/2010 suggest stronger United States growth (-2.5%/+2.7%) than the Eurozone (-3.8%/+1.2%), Japan (-5.4%/+1.5%), or United Kingdom (-4.5%/+1.3%). Stronger economic growth, improving net exports and equity outperformance tends to attract capital flows resulting in currency appreciation. The U.S. fiscal deficit is worsening, but conditions for Japan and Europe are as bad or worse, and their total debt/GDP is still higher.

Deficits Accelerating

"We shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves." ---Thomas Jefferson

Popular theory #8: Another popular myth is that fiscal deficits don't seem to matter much. As long as Treasury bonds are well bid and yields remain low, with the lowest mortgage rates in a generation, why should we be worried about expanding fiscal deficits? Debt from the \$787 billion American Recovery and Reinvestment Act of 2009 has imperiled our future prosperity, burdening the economy with excessive debt, but providing little measurable benefit to our economy. Worse, it likely will be largely wasted if we must hike interest rates faster and higher than otherwise needed once the effect of this stimulus does grab hold, most significantly in 2010. As interest rates rise, interest expense will increase and financial flexibility to address future slowdowns will diminish. It likely will crowd out capacity for future desirable public investment and increase the cost of capital to American businesses. All that was needed to restore liquidity and confidence was achieved by January 2009. Since the banking sector had stabilized and credit formation was improving by March 2009, the fiscal stimulus was not needed by the time it passed and the remainder should be cancelled.

The ability to extract higher tax revenues by increasing individual and/or corporate tax rates is limited. Taxpayers seek to maximize their income. Adapting to changes in tax law can expose new inefficiencies and have an adverse impact on long-term expectations. Relying on market forces of the global economy has historically been the best way to efficiently allocate the resources of a society. This has been proven over many generations. Tax cuts have fared better at every opportunity. America has retained her edge by promoting innovation and being a leader in many industries with the benefit of free markets policies.

Increasing corporate taxes tends to increase inflation while undermining growth. We've tried this before and it appears to be the surest way to drive an economy into stagflation. The weakness of exceedingly progressive state and federal tax regimes has been exposed in this economic downturn in the U.S., as well as Europe, as revenue shortfalls balloon budget deficits. We have never observed any nation throughout history that has been able to tax and spend their way to prosperity and improve quality of lifestyle as a nation. Increasing corporate taxes and regulation on business simply passes through as inflation to consumers. Expanding government spending and increasing regulation won't create wealth, only destroy, limit or redistribute it, thereby undermining our future prosperity and lifestyle.

Popular Theory #9: There is a belief that raising taxes can solve fiscal deficit problems and provide new revenues for desired programs without long-term consequences. Unfortunately, we observe a strong

association between heavily taxed states and countries with those having the greatest difficulty balancing budgets. The United Kingdom and Japan are both in trouble due to soaring debt and are among the most highly taxed nations in the world. Countries with the highest corporate and individual tax rates generally are suffering the most under crippling budget deficits. Is this not true of the most indebted states in our union, as well? Tax cuts tend to incentivize business expansion, job growth, and formation of new companies. We've observed that keeping overall tax rates low increases competitiveness while incentivizing business owners and individuals to maximize their profitability.

U.K. Prime Minister Gordon Brown recently laid out spending plans exceeding \$1tn over the next five years, funded by hiking the top marginal income tax rate from 40% to 50%. Tax rates that are globally uncompetitive or regulations that are overly complex and inconsistent tend to increase inefficiencies, complicate business decision-making, encourage tax-avoidance strategies, undermine pro-growth incentives, and distort the rational allocation of resources. Reasonable and consistent individual and corporate tax policy is necessary for efficient planning and allocation of capital.

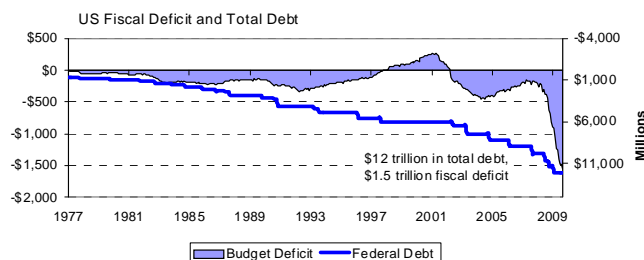
A recent report by Pierre Cailleteau, managing director of Moody's sovereign risk group, concludes that the U.S. and U.K. are currently "AAA countries whose public finances are deteriorating considerably and may therefore test the AAA boundaries." We expect the cost of financing our deficit will rise significantly, as interest rates eventually must increase. If investors required a higher risk premium, it might threaten the benefit America enjoys of being the world's reserve currency.

From 1982 – 1989, our Deficit/GDP plunged from 5.5% to 2.5% following dramatic tax cuts across businesses and households. During the recent crisis, our deficit ratio has jumped from 1.6% to 9.6% and is forecast by consensus to exceed 12% in 2011. We have not experienced such high deficits since World War II. High deficits pass on significant debt, which can crowd out investment and increase financing costs. Once the economy is expanding, fiscal deficits will come down, but our debt will likely remain high for an extended period if we continue on the current chosen path. It is hard to imagine that the current approach to fiscal stimulus will be as successful in reducing the deficit as were tax cuts.

Encouraging innovation, capitalism, free-markets, rule of law, respect for property rights, global competitiveness, incentives for basic research and higher education has driven increasing prosperity, expanding productivity and an enviable lifestyle in America for generations. Voters are growing weary of attempts to fast track complex and incomprehensible legislative bills. Existing entitlement programs provide little confidence that an overhaul of health care will fare any better, given the dismal state of Social Security, Medicare and Medicaid programs. A majority of voters oppose proposed health care reform and the funding of other "new moral obligations". Most

taxpayers simply wanted to pay less for their existing coverage, slow premium inflation, and make it portable. We are growing concerned about new mandates, tax increases and new regulations.

The U.S. Treasury has continued to reduce the average maturity of their outstanding debt and this has become an increasing danger, as long-term obligations commit taxpayers to huge liabilities that will compound at higher rates when interest rates rise. The interest expense on total debt of \$12 trillion is over \$200 billion/year, and the White House estimates that our interest expense will exceed \$700 billion a year in 2019. With interest rates at the lowest level since the 1960s, interest expense may triple as we eventually extend the average Treasury issuance maturity from a 50-year low of 4 years. Mounting fiscal deficits have required the debt ceiling to be raised again to above \$12 trillion. The fiscal deficit in 2010 is now forecast by some economists to exceed \$2 trillion vs. \$178 billion in 2007 and \$190 billion in 2008.



Source: HighMark Capital and Thomson Datastream

The real engine of America's growth for the last 20 years has been small business, but owners are quite fearful of proposed new taxes, increased regulation, and the continued difficulty of tapping credit lines. Sharing the wealth should be a charitable action. Funding new popular giveaways through narrowly targeted surtaxes hardly seems consistent with our founding principles. Eliminating tax deductions on charitable gifts is the only idea more misguided than that. There is more to be gained by government partnering with business to promote growth so that our companies can be competitive globally and attract foreign investment capital, which would bolster the U.S. dollar.

In prior financial calamities we learned that there is a risk of over-regulating and interfering with free markets. Legislative risks to the economy are increasing, as the Administration and Congress seek to expedite legislation, bringing profound changes. An atmosphere of seemingly perpetual crisis may provide enough cover to question our founding principles for a period of time. The more protection government attempts to impose, albeit creating an illusion of safety, the riskier our financial system seems to become. Respect for rule of law requires that individuals read, understand and accept the liabilities of the contracts they sign. Financial crises come and go, but we never seem able to fully insulate the system from all of the possible risks. In every crisis, however, lapses in enforcing existing regulations and morality contribute materially.

How Are Assets Being Allocated?

Since the March 6th intraday low of “666”, the S&P 500 has returned 67%. Investor sentiment has improved and credit spreads have tightened materially. ICI data in 2009 through October suggests that the value of equity mutual funds increased 24%, while the S&P 500 rose by 17%. Net equity flows were insufficient to rebalance equities by the 15-20% needed to restore a balanced portfolio to 60% equity + 40% fixed income exposure, after the 37% S&P 500 decline from September '08 – March '09. Meanwhile, investors increased fixed income holdings significantly. International and emerging market equity funds were also favored. We are concerned further increases in bond yields may result in steep losses for bond investors.

Total Mutual Fund Assets					
Billions of dollars	Oct 09	Oct. Chg	Dec 08	YTD Chg	Market
Stock Funds	4,596	-2.7	3,705	24%	17.0%
Hybrid Funds	605	-0.4	499	21%	12.7%
Taxable Bond Funds	1,683	3.3	1,228	37%	6.2%
Municipal Bond Funds	444	-1.1	338	31%	
Taxable Money Market Funds	2,951	-1.9	3,341	-12%	
Tax-Free Money Market Funds	410	-1.8	492	-17%	
Total	10,688	-1.3	9,601	11%	

Source: ICI (Market returns: S&P 500, 60/40 Hybrid Mix, Barclays Capital Aggregate)

Popular Theory #10: Passively managed Exchange Traded Funds (ETFs) have been pitched as a cheaper alternative to actively managed funds, offering intraday liquidity just like common stocks, and providing access to narrowly focused investment opportunities. ETFs have experienced rapid growth and become an alternative investment for tactical traders and hedge funds. Total ETF equity assets have increased to \$681 billion as of October. The top 200 ETFs total about \$1 trillion after absorbing \$70.1 billion in net flows this year, mostly in equities. ETF products are actually relatively expensive for guaranteed underperformance versus a simple index fund, even before trading costs. Specialized and smaller funds are generally most expensive. We calculated that the top 200 ETFs have an average expense ratio of 0.44%. ETF expense ratios of 35 basis points for iShare MSCI EAFE, tracking developed international markets, and 72 basis points for iShare MSCI Emerging Markets are not insignificant, as popular theory might suggest. While many ETFs are cheaper than actively managed funds, they are expensive relative to index funds and guarantee underperformance relative to their index benchmarks, even before transaction costs.

The cost of trading the underlying holdings to manage cash flows throughout the day, plus commission and bid-ask spread, adds up over time. For long-term investors, passive ETFs are more expensive than index funds, and will typically underperform their respective investment objectives, without the potential upside that active management might provide. These are among the dirty little secrets of costly ETFs.

The Gold Series ETF (GLD) expense fee charges investors 40 basis points on \$41 billion in assets, although it is the fourth largest ETF in the world. GLD is

larger than both iShare MSCI Emerging Markets (\$38B), and iShare MSCI EAFE (\$36B). Gold ETFs are required to hold gold bullion directly, increasing demand and pushing prices above reasonable levels for an investment that has failed to beat inflation over the long-run. GLD seeks to reflect the performance of gold bullion, but has underperformed by 1.48% net of expenses, but before transaction costs. Gold ETFs are treated differently than other fund investments being subject to the 28% tax rate on collectibles, irrespective of holding period. After-tax precious metal returns would have to be much better than stocks to make up for the lower dividend and long-term capital gains tax rate difference, even if held in a fund. We are concerned that many gold investors bought for safety during the financial crisis, but are exposed to high volatility and a potential precipitous decline. The last time central banks expanded their gold reserves in 1980, their purchases preceded a 50% decline in gold prices.

The objective of an ETF is to match the performance of the index. Complex benchmarks or indices with many illiquid securities tend to be more difficult to track. Emerging market equity and even broad bond indices have been particularly difficult to track historically, for example. In comparing two Emerging Market ETFs that track MSCI's index, Vanguard's Emerging Market ETF has outperformed iShare's Emerging Market ETF by 11.1% in 2009 through November. ETFs aren't typically held to the same performance standard of active funds. One should consider the total cost of guaranteed underperformance of passive index funds before dismissing active management. As credit market liquidity seized up last year, it became difficult and very expensive to hold the same fixed income securities in exact proportions as the index. The Vanguard Total Bond ETF returned 4.58% this year, but underperformed the Barclays Capital Aggregate Bond return by -2.32% through November. What sounds good in theory, may not work out so well in real-time. However, nothing could be as disappointing as investing in USO, a popular ETF with a net expense ratio of 0.86%, which seeks to track the performance of West Texas Intermediate Oil spot price. Oil prices have risen 75.6%, but USO returned 18.3% net of expenses this year through November.

Conclusion

We have observed what we believed to be significant tactical asset allocation opportunities this year. Some ideas have played out well, with some possibly having further to run, while others could offer opportunities soon in the opposite direction. We still recommend favoring stocks over bonds. We have suggested that fundamentals are supportive of even higher equity prices, but we do expect volatility to remain high for the foreseeable future, as long as legislative and economic uncertainty is high. It is reasonable to question whether the unprecedented S&P 500 rebound of 67% since March 6th has rallied too far, too fast. We believe global equity markets can appreciate substantially from current levels, if economic conditions play out as we expect.

Rising fiscal deficits must drive up the supply of bonds, even as the Fed is likely to raise interest rates next year. Inflation expectations have remained low, but should begin to increase as economic conditions continue to firm. The Fed has suspended its support of Treasuries through quantitative easing, and cash holdings are losing real purchasing power. We are concerned gold and Treasuries are most at risk for losses, although perceived as safer havens by investors. Historically, commodities have underperformed inflation, which doesn't bode well as an investment for the long-run. Conditions are never perfect, but the balance of risks and opportunity seem to us to favor equities over bonds.

We believe that global growth will be exceptional relative to consensus forecasts and difficult to derail for the foreseeable future. Many skeptics are now rethinking their position as the evidence of recovery continues to accumulate and growth forecasts are revised up. We should not accept that our future is hopeless. Someone else's *New Normal* doesn't have to be our destiny. We do need to identify new growth engines of innovation, however, that can carry us through the next cycle.

Volatility in capital markets remains high and there is great uncertainty about the future direction of economies and capital markets. Popular theories can for work for awhile, but the market must eventually reflect underlying fundamentals. Investor risk premiums are depressed, while Treasury yields remain near record lows and gold prices have soared. Popular consensus expects that the U.S. dollar will continue to weaken, even as the U.S. economy has been, and should continue to outperform most other developed economies. However, popular theories can be misguided and recent gains can be lost quickly. Investment rotations can be slow in developing, but once global re-synchronization takes hold and the

worldwide outlook improves, we believe this significant global re-alignment will offer many tactical opportunities.

Retail investors have generally missed an opportunity, given the net withdrawal from equity mutual funds over the last 15 months. Disappointing performance might be compounded if reallocations into bonds over the last year have chased peak prices (lowest yields). Extraordinary monetary policy has reinforced global re-synchronization. Investor, business, and consumer confidence are all improving. Improving access to credit, securitization, and liquidity, combined with a remarkable resurgence of earnings, suggests to us that stocks have further upside, if earnings rise, as we expect.

Every financial crisis is unique, and we have learned something new from each one. Efforts to tackle perceived weaknesses are inevitable, but often result in overregulation and the introduction of new inefficiencies. Financial reforms inevitably seek to protect against repeating past mistakes, instead of efficiently reinforcing our financial system, including addressing market manipulation and lapses in enforcement, as we've discussed throughout 2009. Soaring uncertainty in this financial crisis has been used to justify various legislative proposals that never would have been credible under normal conditions. Debate about fundamental principles and beliefs is healthy and useful, if for nothing more than to reaffirm our convictions. As investors, we must always challenge our views, question our assumptions, and seek to identify changing trends early. Different isn't necessarily right or wrong, but we believe this point in time holds the greatest potential in a generation to add value, given the dramatic dispersion of views observed.

David Goerz, SVP - Chief Investment Officer

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