

QUARTERLY INVESTMENT OUTLOOK

SHAKEN, BUT STILL STANDING Fourth Quarter 2011

David Goerz, SVP - Chief Investment Officer

Recent surveys suggest grave concern about slowing global economic growth, but are they indicative of an imminent recession or simply a transitional crisis of confidence? Global equity markets have discounted increased risk that current financial, economic and policy headwinds could undermine earnings. While we have noted a double dip recession is technically not possible after the economy has expanded for 26 months since June 2009, we also don't expect the U.S. economy will tip into recession again for the foreseeable future. We do not dismiss obvious concerns, from natural disasters to the various economic, financial and geopolitical sources of uncertainty, enumerated below. Yet, the roots of this slowdown don't run very deep, in our opinion, given the now moderating causes of what we expect is a Q2 transitory pause. So, our outlook is for the global economy to continue expanding through 2013.

Much of the economic data observed doesn't justify the level of pessimism evident in sentiment surveys. Recent "hard" data observations, including retail sales, business sales, industrial production, exports and business investment imply the economy is still expanding. Meanwhile, there is intense focus on business and consumer confidence surveys ("soft" data), which are weakening precipitously, amidst high unemployment and many other sources of uncertainty, including questions about the governing effectiveness of political leadership in the U.S. and Europe. Indeed, Standard & Poor's cited "political brinkmanship" in their downgrade of U.S. government debt from AAA to AA+. We often contrast the notions of Wall Street vs. Main Street and "wallet confidence" vs. consumer sentiment. If consumption and business investment are such important drivers of growth, why don't investors more actively embrace: Watch what I do, not what I say. We suggest survey responders seem to have diverged from their observed consumption and investment spending oriented mindset.

Sentiment changes are rarely leading indicators---more often they lag, and are simply a reflection of public perceptions. Thus, by definition, how can an investor gain an edge by relying on confidence surveys to anticipate future economic growth, earnings or stock market returns? Weakness in consumer and business sentiment is only marginally correlated with bond returns, but has never exhibited correlation with economic growth, earnings or market returns useful for forecasting. Rather, weakening confidence is a more reliable contrarian indicator, reinforcing the Wall Street adage, "buy when there is blood in the streets". Trends in confidence must be confirmed by "hard" economic data or consigned to be a false positive. The economic forecasts shown below hardly support low equity valuations and record low real interest rates:

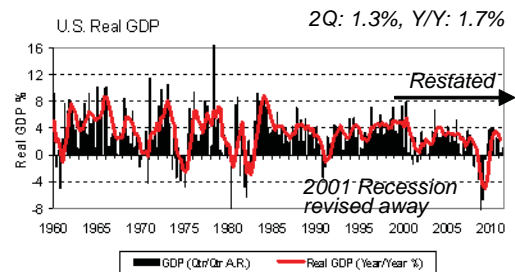
Economic Forecasts	2008	2009	2010	2011e	2012e	2013e
U.S. GDP (Y/Y Real)	-3.4	-0.6	3.2	2.0	2.5	2.8
Earnings Growth	-26.6	-5.6	43.4	14.6	10.4	3.8
CPI Inflation (Y/Y)	-0.0	2.8	1.4	3.0	2.5	2.5
Unemployment	7.3	9.9	9.4	9.0	8.4	7.8
Fed Funds Target	0.25	0.25	0.25	0.25	0.50	1.75
Treasury Notes-10y	2.25	3.84	3.31	2.63	3.38	3.88
S&P 500 Target	903	1115	1258	1300	1440	1550

Source: HighMark Capital estimates and Thomson Datastream

We continue to monitor the potentially adverse impact of six global concerns¹. These headwinds have left investors Shaken, But Still Standing. As these transitional concerns have faded or begun to moderate, we believe economic expansion will continue for the foreseeable future, as long as inflation remains contained. Tightly coiled potential business and consumer demand, restrained over several years, should support above average demand, given five economic drivers HighMark introduced Q1/2010 as our Big Ideas for 2010². Only housing has disappointed.

Slower Growth, Not a Recession Precursor

Revised U.S. GDP suggests economic growth has slowed, but the data is inconsistent with other measures of economic conditions, including retail sales, business sales, nonresidential investment, exports, and industrial production. More frequent monthly data suggest the economy has started re-accelerating, so many economists expect Q3 GDP to exceed 2% growth. This suggests to us that the economic slowdown is more likely a mid-cycle transitory pause that is similar to 2010, than a precursor to another recession.



Source: HighMark Capital Management and Datastream

¹ Sources of uncertainty: (1) Global supply chain disruptions in automotive and technology sectors due to the Japanese earthquake, (2) Monetary policy tightening in emerging market economies, Australia and European Union, (3) Higher oil prices and destabilized Middle Eastern and North African governments resulting from the Arab Spring uprisings, (4) European debt crisis and need for developed countries' fiscal austerity and (5) Rule making uncertainty finalizing health care and financial reform regulations, including Basel III capital requirement and other policy changes under consideration, (6) Effects of unusual weather, including winter storms, tornados, flooding, and wildfires in drought regions.

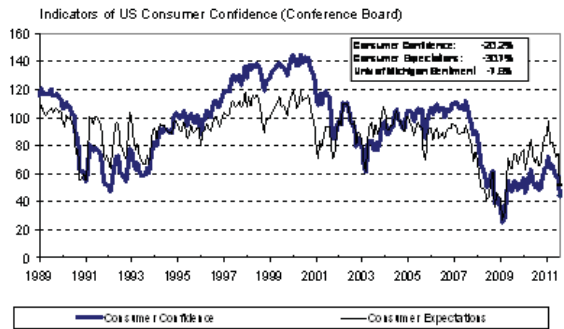
² Demand drivers: (1) business investment (2) inventory re-stocking (3) export growth (4) housing starts (5) consumption

Recent Bureau of Economic Analysis' (BEA) revisions to U.S. Gross Domestic Product (GDP) data have amplified fears that the economy may be tipping into recession. The revisions erased almost \$400 billion of real output over the last decade, mostly due to use of an alternative methodology and new data sources. Current record GDP of \$15.0 trillion has still surpassed the pre-crisis peak of \$14.4 trillion during Q2/2008, but post-revision real GDP in Q4/2008 of -8.9% compares to -6.8% reported previously. Data revisions continue to swing wildly in both directions around initial estimates, which diminish the usefulness of this measure of economic growth. Given the complexity of national accounts data, few economists have dared to unravel this puzzle yet. The few details about the seemingly random calculation adjustments from BEA are sketchy at best, but that hasn't limited the adverse impact on economic confidence. HighMark forecasts GDP primarily as a reference for communication, but our econometric models are built upon more stable monthly data series, subject to less revision and qualitative interpretation.

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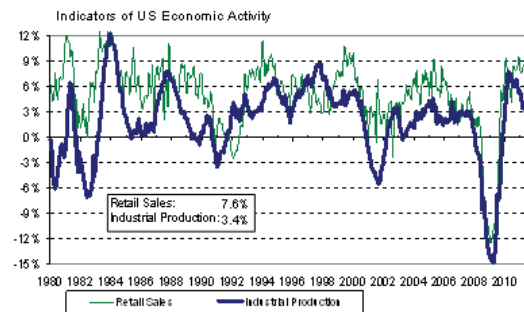
Another peculiarity of the GDP revision was the sequential growth rate observed in 2011. Economists revised growth estimates upward earlier this year after stronger Q1 data confirmed the expansion was on track. After the revision, Q2 growth of 1.3% was stronger than the 0.4% Q1 growth, even though transitory headwinds didn't emerge until Q2. The overall effect is about 1% slower annualized growth during the first half of 2011, of which about half is related to the GDP revision. Most investors have simply accepted this new baseline, but we think the GDP revision required lowering forecasts, including our own, more than is warranted by a moderately slowing economy. Finally, we observe a widening gap in 2011 between GDP and Gross Domestic Income (GDI), which implied real gains of 2.5% and 1.3% in Q1 and Q2, respectively, both exceeding the 0.8% average gain for real GDP, using the same inflation rate. GDI is calculated from tax receipts, but no one pays taxes unless they actually earned income. GDP and GDI are equivalent in theory.

Plunging sentiment surveys have seemingly pushed economic forecasts lower. This is the topic of a recent paper titled "Consumer Sentiment and Spending" by Ross Devot of the Milken Institute. He found Congressional approval surveys exhibit greater correlation with sentiment, than with economic variables. We don't attempt to forecast sentiment since it is of little value when forecasting the economy or markets. It does suggest an alternative or complement to economic causes for falling sentiment, amidst record low job approval of politicians. Political gridlock and an increasing gap in policy ideologies remains a hurdle to addressing critical fiscal problems. Lack of voter confidence in government effectiveness likely will compound economic concerns in the next election.



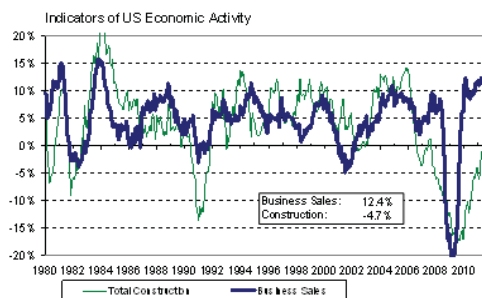
Source: HighMark Capital estimates and Datastream

Despite the lack of statistically significant empirical evidence, investors seem inclined to use confidence surveys as a leading economic indicator lately. Confidence only declines after a majority has expressed a view, and thus, is already discounted by markets. Heightened market volatility has surely exacerbated falling confidence. Contrast the chart above with the remarkably resilient "hard" economic and earnings data below. While security and asset class correlations have risen, expanding valuation divergences provide relative investment opportunities as markets normalize. Shaken by equity volatility, it is hard not to be swayed by the crowd, enamored with a "new normal", or tempted to abandon one's investment principles. There are no short-cuts and no new asset classes that can provide a superior long-term reward vs. risk ratio to any point on the efficient frontier for capital markets.



Source: HighMark Capital estimates and Datastream

Housing has troughed, but failed to normalize yet despite low interest rates, increasing affordability, and housing starts still 50% below the average household formation rate of 1.3 million/year. The construction sector harbors the highest unemployment rate, so employment growth hinges on housing. U.S. household formation is near the lowest level since World War II, which troughed at 357,000 according to the Census Bureau for the year ending March 2010. Household formation is the driver of growth in housing demand, so with expectations exceeding 750,000 in 2011, housing starts should accelerate, particularly if confidence improves. We believe increased housing activity would spur business sales and employment.



Source: HighMark Capital estimates and Datastream

High unemployment and weak housing demand are the most recognized domestic concerns. Less visible, has been the deleveraging of households and businesses, following the rapid expansion of credit prior to 2007. Refinancing at lower interest rates reduces interest expense, which combined with deleveraging, has significantly reduced the strain of debt and leverage. Most U.S. imbalances observed in 2007 have become more manageable, supported by strong cash flows.

Drawing parallels with the 2008 financial crisis has become increasingly common, but we must differentiate between economic, financial, geopolitical and fiscal crises. While historical analogies make it easier to understand complex relationships, such comparisons can also be treacherously misleading. The impact, lingering effects and most effective policy response are very different depending on the type of crisis and cause of imbalances. Cutting interest rates and providing liquidity is the best way to address a financial crisis, but may not help much with a fiscal crisis. Bank solvency and mortgage concerns of 2008 were different problems than increasing government fiscal deficits with high debt levels observed today. U.S. banks have improved their capital ratios, while non-financial companies hold more than \$2 trillion in cash. U.S. companies hold \$1.3 trillion in offshore retained earnings. Households have deleveraged with net worth increasing \$9.1 trillion to \$58.4 trillion since Q1/2009. So, resilience to a U.S. financial crisis is high, although we expect the European fiscal crisis will take more than a year to resolve.

We believe companies have many reasons for retaining such high cash levels, beyond just the various sources of uncertainty we identified above. The roughly 40% decline in commercial paper outstanding since 2008, which included structured investment vehicles (SIVs), seized up during the financial crisis and issuance hasn't recovered much since. Commercial paper issuance was a cost-efficient means of financing short-term debt for working capital, asset-backed loans, receivables or other needs. Companies seem to be retaining higher cash levels to cover seasonal cash flow needs, while others hunt for acquisitions, contemplate large share buybacks, investment spending, or seek to expand their workforce once there is economic clarity to do so.

What Can Central Banks Do?

Before 1977, the Federal Reserve's mandate was to maintain price stability -- to preserve the currency as a store of

value, but was revised to include "maximizing employment". The expanded mandate is unusual for a central bank. The Fed has purchased \$2 trillion in bonds since 2008 seeking to increase liquidity and, more recently, drive bond yields lower in order to bolster business investment and housing. Yet, some believe quantitative easing has undermined our currency as "a store of value", pointing to the sharp rise in the price of gold. There has been no expansion in credit attributable to QE-2. Thus, many economists believe that QE-2 failed in its objective as bond yields rose and inflation ratcheted higher. Treasury yields are at a 60-year low, so further quantitative easing (QE-3) or extending the average maturity of the Fed's balance sheet would likely be ineffective. Federal Reserve dissenters Fisher, Plosser and Kocherlakota have argued that additional monetary policy accommodation is not warranted now.

The Federal Reserve "output gap" steering monetary policy believe that slack in unemployment is too high to result in inflationary wage increases, and excess capacity limits investment spending. If there is too much slack, why have unit labor costs accelerated from -5.1% just over a year ago to +0.7% and rising today? High unemployment of 9.1% has co-

incided with surprising growth in job vacancies and weekly earnings increases averaging 2.5-3.0%. Meanwhile, capacity utilization has risen 10% from its trough in May 2009 to 77.4%, closing in on its long-term average of 80.4%. Even real non-

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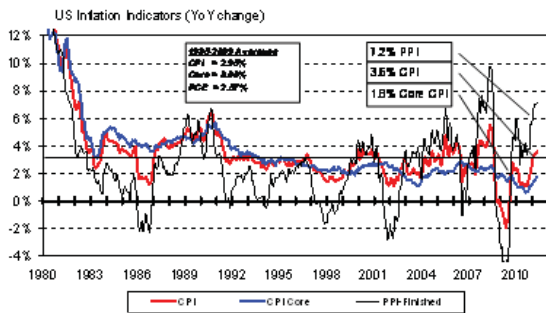
residential fixed investment accelerated to 9.9% growth in Q2. Interest rates have been pegged near 0% since December 2008 despite improving economic conditions and rising inflation. Credit should be expanding much faster with money growth exceeding levels last observed in January 2009, given the rapid 32% increase in the monetary base and 21% increase in M1. Only large banks and corporations seem to be able to take full advantage of such low interest rates. Is it appropriate to maintain such loose monetary policy as if it were March 2009 at the height of the financial crisis?

In October 2008, the Federal Reserve began paying interest of 0.25% on bank reserves, which is a better rate than the yield on 2-year Treasuries. Taxpayers have been indirectly footing this interest expense, albeit while helping to rebuild U.S. bank balance sheet strength. New regulatory capital requirements of Dodd-Frank legislation and Basel III have raised the bar even higher. Banks have restrained lending in a way that suggests paying interest on reserves is aggravating credit expansion. Fixing the Fed Funds rate with a date-certain time horizon offered little to those still unable to borrow easily due to tight credit standards.

Ignoring the Inflation Threat Is Perilous

We are growing concerned that the longer normalizing forces persist, the greater the likelihood that inflation will become entrenched, and therefore, more difficult to contain. Rising

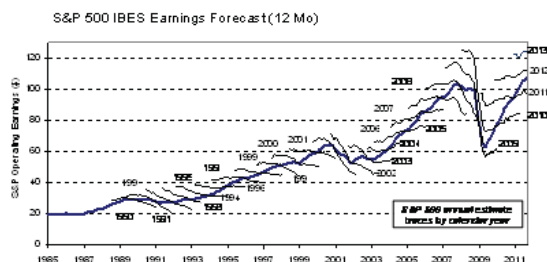
commodity indices fed into producer prices, and has started feeding into consumer prices (CPI), including the 32% share attributable to housing. Rent equivalent prices have increased 1.4% versus deflation observed from July 2009–November 2010. Inflationary forces today are different than observed in 2007. CPI inflation is 3.6% and trending higher, averaging 4.1% so far in 2011. However, negative real bond yields have plunged to record lows, suggesting there is little concern for accelerating inflation. Even after S&P downgraded U.S. Government debt, there was no credit spread to mistake for an inflation risk premium. The Federal Reserve still holds influence over investor expectations, but inflation can become problematic if the Fed continues to dismiss rising prices and wages. Globalization of inflationary forces has triggered interest rate increases from Norway to the Eurozone and emerging markets. The Fed will need to hike interest rates as economic growth and inflation normalizes.



Source: HighMark Capital estimates and Datastream

Earnings Growth and Valuations

Earnings drive stock prices. There is no evidence the trend in earnings growth is dissipating after reporting another quarter of strong Q2 earnings with 72% of S&P 500 companies beating March 31st estimates by 6.3%. Analysts continue to ratchet up expected earnings toward \$98, which would exceed the previous 2006 peak of \$88 by a wide margin. We observe from the chart below that earnings trend for extended periods of 5-10 years, although the annual growth rate may vary. Inflection points in earnings are caused by recessions, but sufficient triggers are not apparent yet.

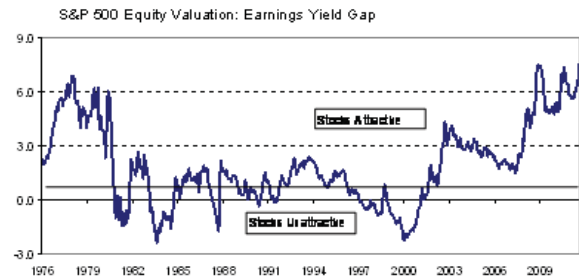


	2013e	2012e	2011e	2010	2009	2008	2007
HighMark	3.8%	10.4%	14.8%	43.4%	-5.6%	-26.5%	-4.6%
Consensus	11.7%	13.3%	16.7%	43.4%	-5.6%	-26.5%	-4.6%
HighMark	\$ 110.00	\$ 106.00	\$ 96.00	\$ 84.15	\$ 58.40	\$ 61.48	\$ 85.12
Consensus	\$ 123.84	\$ 110.83	\$ 97.79	\$ 84.15	\$ 58.40	\$ 61.48	\$ 85.12

Source: HighMark Capital estimates and Thompson Datastream

Plunging equity market valuations have discounted this crisis of confidence as if foretelling a steep economic recession. Cyclical industrial, technology, and banking stocks

are among the abused-then-abandoned, heaped onto the pile of neglected companies that are very cheap based on a variety of measures. With strong earnings revisions pushing up 2011 S&P 500 forecasted earnings toward \$98, the recent decline in equity prices drove the earnings multiple below 11X and 2012 estimates to less than 10X earnings. S&P 500 dividend yields of over 2% now exceed 10-year Treasury yields. Equity valuations are very compelling, in our opinion. From the fixed income perspective, the stock market P/E would need to rise to 55X to reach parity with Treasury yields.



Source: HighMark Capital estimates and Datastream

Growth in emerging market countries has recently moderated with tighter monetary policy, including interest rate hikes. Emerging market growth has become more cyclical, but secular drivers of urbanization and insatiable consumption still persist. Steep declines in equity indices, plus strong earnings growth, pushed most emerging market valuations to attractive levels. Any easing of monetary policy should be viewed favorably. Our theme of global synchronized recovery is finally showing signs of maturity as national interests diverge, exposing regional opportunities within asset classes.

Long Workout Ahead For Europe

Europe has devolved into a fiscal crisis, exacerbated by lingering post-financial crisis economic weakness and inferior global competitiveness. European banks were not as aggressive as U.S. banks about raising capital during 2008-2009. So, investors fear their weaker capital ratios may not withstand writing-off Eurozone sovereign debt holdings if restructuring extends beyond Greece and Portugal. We don't think expected Eurozone austerity, slowing the growth of spending, will detract much from global growth, even as European banks battle uncertainty about any eventual "haircut" to government debt. The European periphery represents less than 7% of global GDP. If the Eurozone weaklings contract by -4% in 2012, the impact to expected global growth of 3.7-4.0% will likely be less than 0.3%.

We should expect that the European debt crisis workout will be difficult. In establishing the €750 billion European Financial Stability Facility (EFSF), distressed Eurozone countries were required to slash projected fiscal deficits. Most assume Greek debt will need to be restructured, but Italy and Spain could manage through this crisis with meaningful fiscal reform. A "Brady Plan", like the one developed to restructure Latin American debt, could reduce Greece's debt burden and provide the best outcome for bond holders by extending maturities, lowering interest rates, and offering a credit en-

hancement backed by the IMF and European Union.

Improving productivity takes years, so exchange rate adjustments have been the most expedient mechanism to offset faltering relative competitiveness. Floating exchange rates provide a way for countries that have failed to promote growth and productivity to reset their competitive advantage. Consequences for any particular economy vary, but typically a falling standard of living and higher inflation tend to result in regime change.

Over the next decade, Europe must choose enforceable fiscal discipline or face social collapse. Greece is unlikely to leave the European Monetary Union (EMU), but Germany might, and could withdraw if the cost of supporting a Euro currency became too great. Without fiscal union, there has been no supranational government managing EMU. The European Central Bank (ECB) has little influence over sovereign fiscal policy, thus there were no consequences to exceeding targets set by the Maastricht Treaty. Countries that routinely exceeded fiscal deficit targets have struggled most with an ever increasing productivity gap versus Germany, who pursued labor market reform beginning in 2003. They also struggled with competition from Emerging Markets and developed economies that leveraged well-positioned industries with a sustainable advantage. Countries such as Canada, Australia and Brazil alternatively enjoyed the benefit of leveraging rising natural resource prices.

The ECB has hiked interest rates by 0.5% this year, while allowing money supply growth to turn negative. These policy actions have exacerbated the region's economic slowdown. In 2007, the ECB made a similar mistake when rising commodity prices drove higher inflation, only to reverse course a little over a year later. With commodity prices skidding recently, there is an opportunity for the ECB to cut interest rates by 0.5%, which would likely also weaken the Euro.

Conclusion

"One of the great mistakes is to judge policies and programs by their intentions, rather than their results."

-- Milton Friedman, 1975

We have suggested the recent economic slowdown was driven by six identified transitory headwinds that seem to be moderating with the passage of time. Declining sentiment and increased investor risk aversion suggest increased probability of another recession, but conflict with observed "hard" data. Cognitive and emotional biases are difficult to overcome after investors have been devastated by two equity bear markets in a decade. It is only human to seek comfort in the consensus, but this is why it is so important to be grounded in an objective investment discipline to lean on in such times of uncertainty. Plunging sentiment without confirming economic data suggests to us there can be significant upside to global equities, supported by normalizing equity valuations and rising earnings through 2013.

Investors also seem complacent about fixed income valuations after a 30-year bull market in bonds drove 10-year Treasuries from 15.3% in September 1981 to a low of 2.25%

in December 2008. For bonds to normalize, bond yields must rise above 5.5% from 2.0% today, or 2.5% above CPI inflation that has averaged 3.0% over the last 60 years. We believe that Treasuries are significantly overvalued, and the total return for 10-year constant maturity Treasuries will likely average less than 2% return over the next five years. High-grade corporate bonds might provide 0.5% better than that, but longer duration portfolios may return less than 1%. Such low expected fixed income returns have dramatic implications for investment policy decisions, particularly if inflation continues to average 2.5-3.0%.

We have observed that even the greatest emotional challenges to investor confidence do not last long. We can't predict changes in confidence, but observe market recoveries with depressed sentiment are usually swift. Social unrest and protests across Europe emphasize the need to address politically difficult fiscal decisions promptly across Europe, as well as in other deeply indebted countries. The European debt crisis provides forewarning to other nations with deteriorating fiscal deficits, even as they enjoy ultra-low interest rates. Most importantly, when we overcome great challenges, America rebounds stronger than before.

Investor concerns are most focused on global economic growth, but inflation is feeding into prices of goods and services. In the U.S., we should expect tighter fiscal and monetary policy, including the need to hike interest rates before 2013. We also expect tax policy reforms and increasing debt issuance, particularly Treasuries. Higher inflation than expected, which drives up interest rates, is the most likely economic concern that could derail the expansion and robust profit margins in the foreseeable future. Finally, thousands of regulations still need to be finalized, resulting from passage of health care and financial reform. We don't dismiss any of these concerns, but we weigh them relative to many U.S. and global economic positives, while awaiting catalysts that refocus attention on valuation and remarkable earnings growth. We think capital markets already priced in a dire scenario, given risk premiums evident in yield spreads and relative valuations, so there isn't much to gain being cyclically defensive, even if economies weaken further.

"Most importantly, when we overcome great challenges, America rebounds stronger than before."

We remain overweight global equities, with a preference for U.S. and emerging market stocks vs. international developed markets. Emerging Market equity valuations have improved between rising earnings and recent underperformance. They have also tightened monetary policy as inflation has ratcheted higher, slowing their demand for imported goods. If commodity prices moderate further, emerging market profit margins could improve materially and increase the likelihood of reversing tighter monetary policy and interest rate hikes. We have slightly reduced global equity exposure, but increased exposure to high-yield bonds. We revised up our U.S. inflation forecast, adjusted down economic growth forecasts, and pushed out first hike in U.S. interest rates to 4Q/2012, but like the Fed, we will continue to monitor evolving economic conditions.

HighMark's tactical asset allocation models are forecasting U.S. equity returns in excess of the compelling March 2009 expected return. The S&P 500 returned over 50% during the subsequent year. Treasury return expectations are the most negative since January 1980. Given the crisis of confidence gripping global capital markets, it is not surprising forecasts are so extreme. We continue to underweight bonds, particularly Treasuries. We would avoid most defensive equity and fixed income sector tilts, which tend to be expensive.

Most importantly, we have to keep in mind what really matters when forecasting economic conditions and future market returns. Sentiment and confidence surveys are not forward-looking. Furthermore, rarely does "it is different this time" work out well for investors. Business and investment cycles have unique characteristics, but valuation, earnings growth, and relative pricing relationships that historically drove market returns over the last five decades are just as relevant today. With so many economic and geopolitical cross-currents, it can be easy to misinterpret any particular cause-and-effect, but there are a few things we know to be true. Investors are never worse off with a well-diversified portfolio, even when market correlations are high, and most of the time they are better off. Rebalancing to a well-defined policy or tactical asset allocation target is never more important than when markets are most volatile. Indeed, excessive market volatility has been unsettling for investors, but with a fundamental foundation, investors can opportunistically exploit dramatic asset class valuation differentials. As investors, we are "Shaken, but Still Standing" true to our discipline.



David Goerz
Chief Investment Officer

David Goerz joined HighMark Capital in 2003 and has more than 21 years of investment management experience. Mr. Goerz provides leadership to all of HighMark's investment activities, manages several HighMark mutual funds, as well as chairs the firm's Asset Allocation and Investment Policy Committees. He regularly appears as a guest on the three primary business news networks, and is quoted frequently in various investment news periodicals.

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