INVESTMENT STRATEGY COMMENTARY

MARKET UPDATE- WHAT'S BEHIND THE DOWNTURN?

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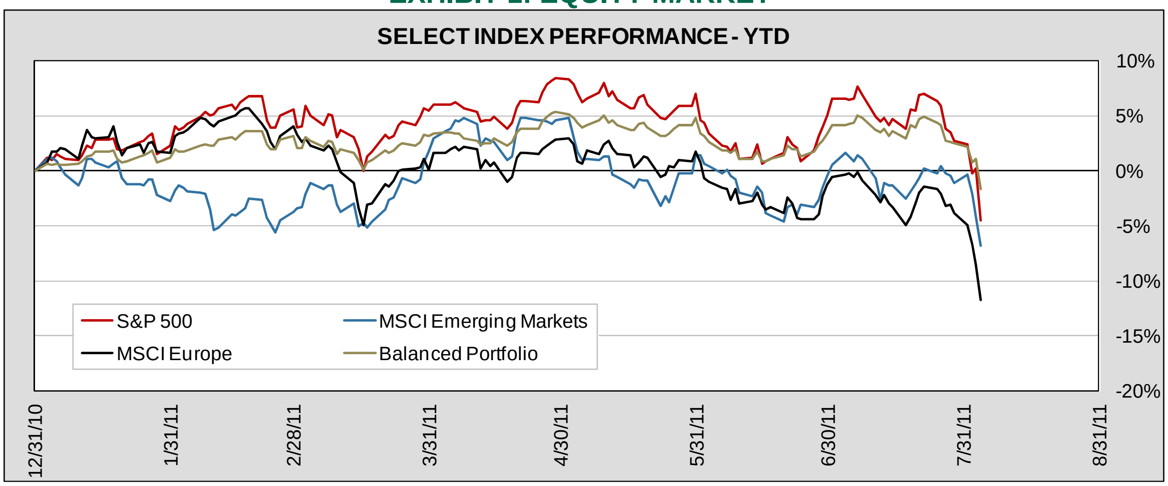
After a strong first-half of 2011, equity markets started to weaken in late July due to three main events (in order of importance): slowing economic data, the continuing European debt saga, and the U.S. debt ceiling negotiations. Going forward, we think the European debt saga will likely supplant the global economic outlook as the primary risk factor for the equity markets. While the U.S. debt ceiling negotiations were very high profile and generated a disappointing outcome (see our recent report titled *The Debt Ceiling Deal: Hold the Applause*), we don't think the bond market ever really lost confidence in the creditworthiness of U.S. Treasuries. This is evidenced by the continued rally in Treasury securities and we think is supported even if the U.S. AAA rating is downgraded – as we believe most fixed income investors already believe this is a likely outcome over the next 12-18 months.

EXHIBIT 1: EQUITY MARKET



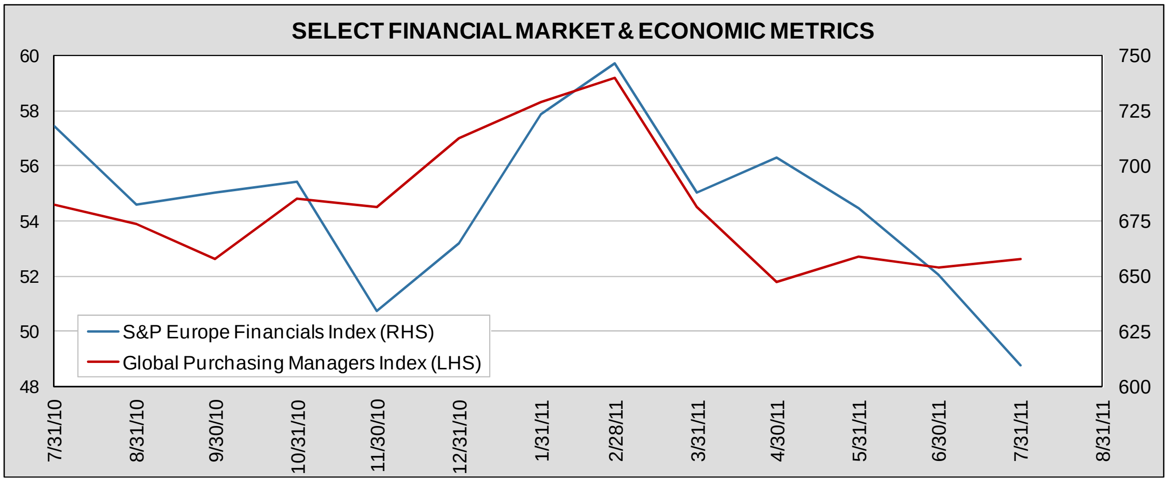
Source: Bloomberg, Northern Trust Global Investments. Data through 8/4/2011.
Note: Balanced portfolio consists of 60% Wilshire 5000 stocks, 40% Barclays Capital Aggregate Index bonds.

Stepping back from the day-to-day news flow, the slowing growth and sovereign credit problems are both a result of the post-financial crisis deleveraging that we have been experiencing since 2009. We have been expecting sub-par economic growth from developed countries during the deleveraging period, as savings rates increase and government austerity plans take hold. Part of the global rebalancing that needs to take place includes slower growth and higher savings in the developed economies, with the emerging markets increasingly moving from export- and infrastructure-dependent growth to a more domestic consumption-oriented model. This process will not always be smooth, as the current economic slowdown is demonstrating. Additionally, the nature of credit risk has changed, as debt burdens have shifted from the private sector to the public sector. We see a much stronger global financial system today, but at the cost of a more indebted and credit-challenged public sector in the developed world.

WHAT IS THE OUTLOOK?

The outlooks for the European debt crisis and global growth are somewhat interconnected, as stronger growth will ease the debt crisis, while degradation in European bond markets could restrict lending and hinder growth. We continue to believe that the relevant policy-makers (the European Union, European Central Bank and the International Monetary Fund) will reluctantly step up continued support at the last possible moment. This has happened so far with Greece, but some aspects of the package (such as the ability of the European Financial Stability Fund to buy bonds in the open market) aren't yet completed. This has left the ECB to re-start its bond-buying programs to provide support to Greek and Portuguese bonds. Worries about European banks' holdings of government debt have pressured their shares, which have fallen nearly 20% year-to-date. The crisis has exposed the principal weakness in the European Monetary Union structure – a lack of fiscal union to match the monetary union. The end game here, whose pace will be set by the political timetable, has to be increased fiscal union with the possibility of a common Eurobond.

EXHIBIT 2: WORRIES ON GROWTH AND EUROPEAN CREDIT



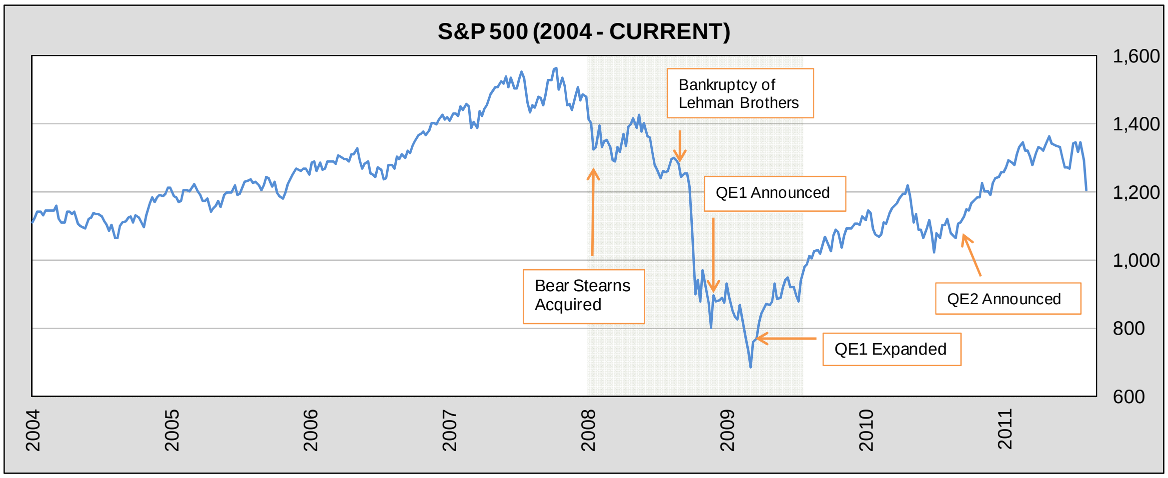
Source: Bloomberg. Data through 7/31/2011.

The global economy is clearly in the middle of a slowdown, initiated by the Japanese natural disaster and high commodity prices. The bounce in global growth anticipated to start in the second quarter has been disappointing so far. Evidence of a sharp rebound in Japanese industrial production has been occurring, but the follow-through in other developed economies has been less impressive. Still, the global purchasing managers' index (both manufacturing and services) has modestly increased over the last three months, after a significant drop earlier in the year. We remain of the view that the global economy will continue to grow over the next couple of years, and that the U.S. economy will skirt recession. We do not appear to have excess in the cyclical parts of the economy that would typically shrink to cause negative growth, but we wouldn't be surprised to see second-half 2011 growth in the 1%-2% range. The July employment report, while only a single data point, provides a glimmer of hope with overall job gains of 117,000 and increasing hourly wages. Private businesses added 154,000 jobs while governments shed 37,000 (23,000 were tied to the temporary shutdown of the Minnesota government), a trend of rebalancing that is healthy for economic growth.

ARE WE GOING TO HAVE A REPEAT OF 2008/2009?

The financial crisis of 2008, leading to one of the worst bear markets of the last 100 years, was primarily the result of over-leverage in the private financial system, exacerbated by the unexpected failure of Lehman Brothers. Before the Lehman bankruptcy, investors thought they knew the rules of the road – including the belief that no systemically important financial firm would be allowed to fail. The shock impact, and unintended consequences, of the bankruptcy significantly magnified the losses throughout the financial system.

EXHIBIT 3: FINANCIAL CRISIS KEY EVENTS



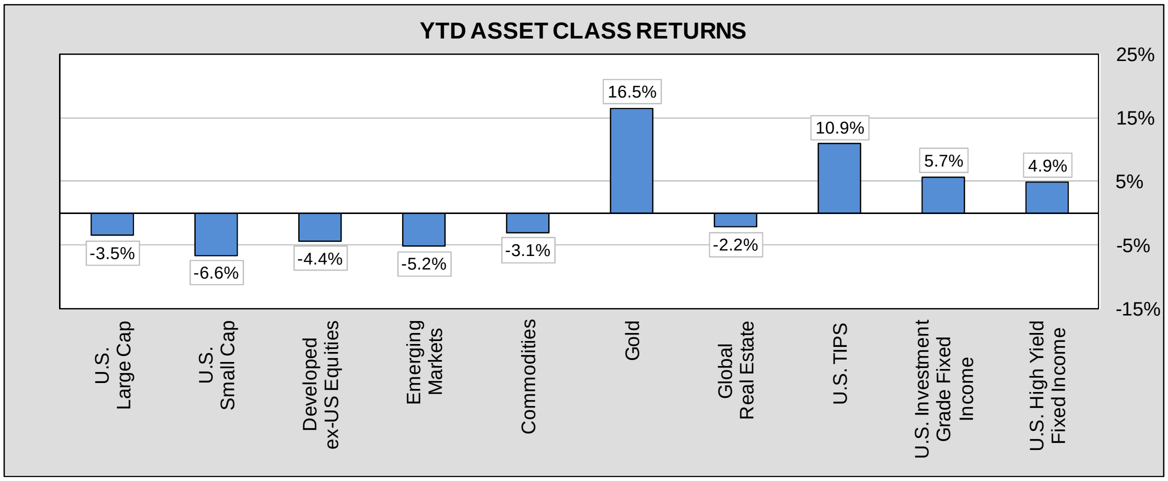
Source: Bloomberg, Northern Trust Global Investments. Data through 8/4/2011.
Note: Shaded area indicates recession.

Our current situation shares the feature of excessive debt, which now resides on the balance sheets of the major developed countries. We believe the systemically important financial institutions are in significantly stronger financial condition than in 2008, as a result of deleveraging and increased regulatory oversight. We are not seeing significant strain in the credit markets for these firms, increasing our confidence that the financial system is stronger than in 2008. Instead, the strains are appearing in select governmental debt markets (primarily the over-indebted Southern European countries). For this debt situation to provide a "Lehman-like" shock to the financial markets, we would likely need a major surprise out of Spain or Italy. We can't rule this out, as the yields on their 10-year notes have reached the 6.0% level, but our base case remains that Europe will limp through the crisis by doing the minimum required at the last possible moment. As a partial hedge against this considerable risk, we currently view U.S. equities more favorably than EAFE (Europe, Australasia and the Far East) and we continue to view gold as an attractive hedge.

HOW HAVE VARIOUS ASSET CLASSES PERFORMED?

While the equity portions of portfolios have lost money during the market decline, the appreciation of bonds has softened the impact in balanced accounts. A primary role of bonds in a portfolio today, in this low-yield environment, is to provide stability during periods of market turmoil. This increases the odds that investors can stick to their long-term asset allocation. Investing in gold can be thought of the same way – it provides a hedge against the credit and political risks we worry about, and its strong performance during recent difficult markets helped offset weakness in the equity markets.

EXHIBIT 4: BONDS AND GOLD GENERATING POSITIVE RETURNS



Source: Bloomberg. Data through 8/4/2011.

Valuation is not a short-term timing device but can be critical to long-term returns. The recent declines in equity markets have brought some additional value to the stock markets. U.S. large- cap stocks are trading at 13 times trailing GAAP earnings, compared with a historical median (since 1955) of 17 times. Developed ex-U.S. equities trade at similar valuation levels, while emerging market equities trade at a price/earnings multiple of 11.6 – compared with a historical median of 14. Illustrating the valuation differential between stocks and bonds, more than one-half of the Dow Jones Industrial Average stocks currently sport a dividend yield above the U.S. Treasury 10-year yield of 2.40%. In a more normal economic environment, these valuation disparities would be compelling. In today's environment, they reflect the increased risk premium investors are demanding due to the continued reliance on monetary policy support to stoke economic growth and financial market stability. Should the economy start to show some organic growth potential, these valuation levels could support renewed momentum in the stock markets. This economic outlook, along with the developments in the European debt markets, will be a key focus of our next Investment Policy Committee meeting in mid-August.

Special thanks go to Phil Grant and Emmanuel Bernabe for data research.

Credit quality ratings are based on the conservative average of Moody's, Standard & Poor's and Fitch ratings. If ratings from all three rating agencies disagree, the model assigns the middle rating to the security. If two of the three agree, the model assigns the rating from those two to the security. If none of these three rating agencies has assigned a rating, the Fund will assign a rating of NR (non-rated security). The ratings, expressed in Standard & Poor's nomenclature, range from AAA (extremely strong capacity to meet its financial commitment) to D (in default). Short-term ratings, expressed in Standard & Poor's nomenclature, range from A-1 (obligor's capacity to meet its financial commitment on the obligation is strong) to A-3 (exhibits adequate protection parameters). The ratings represent the rating agencies' opinions of the quality of the securities they rate. Ratings are relative and subjective and are not absolute standards of quality.