Interim Market Correspondence
March 15, 2011

What about inflation?

If you're looking for an economics lesson on the importance of not saving for the future, it doesn't get any better than this video, which is definitely NOT endorsed by anybody in the financial services profession: http://www.youtube.com/watch?v=wmrO8Jq4cH4&feature=related.

And if you want to see how you, too, can replicate the remarkable success of Goldman Sachs since it bet heavily against its customers and nearly wrecked the American economy, here's the formula: http://www.youtube.com/watch?v=cddjB-k6QOk&feature=related.

Meanwhile, how worried are you about inflation? Some of us remember 1962, when the cost of a loaf of bread ran to 20 cents, a movie ticket cost 50 cents, a gallon of gas set you back 31 cents (unless there happened to be a price war among local service stations), and you could buy a fancy new car for $2,500. Of course, the median family income back then was $6,000 a year (today its $55,000, according to a web site called Baby Boomer HeadQuarters; http://www.bbhq.com/prices.htm).

Go back further and you can see that these prices seemed awfully dear to the generation who remember that in 1916 (according to a web site called The Food Timeline) a loaf of bread cost 5 cents, and on the same shopping trip, you could buy a pound of sugar for 8 cents, a 10 pound sack of potatoes for 27 cents, and a pound of navy beans for 11 cents.

The point here is that people on a fixed income, or whose retirement dollars don't rise with the inflation rate, can budget for one set of costs and then be confronted with monthly expenses that might be double, triple or more what they were accustomed to paying back when they were making their retirement plans.

After 2008, many investors are more worried about the ups and downs in the market than the slowly eroding value of their dollars. But today, we're starting to hear about inflation once again--and the possibility that the slow leak could become something more dangerous to retirement incomes in the fairly near future. How often do you hear the Federal Reserve Chairman say in public that he would welcome a bit more inflation? How often do we hear economists tell us that the easiest way out of the U.S. debt crisis is simply to print more dollars, devalue the currency and pay creditors like China with 50 cent dollars? A weaker dollar would also help close the persistent gap between U.S. imports and exports.

When you look at the actual numbers, they suggest that since the end of 2007, and particularly during the economic meltdown in 2008 and 2009, the government has been injecting dollars into the global economy at an unusually high rate.

How high? The government's web site notes that M1--total currency, traveler's checks, demand deposits and other checking account deposits--has risen 10% over the 12 months ending February 2011. M2, which adds in savings accounts and money market funds, grew at a 4.1% rate, but has risen 18% since the end of 2007. The last count shows that there are roughly 8.89 trillion dollars in the global economy. As you can see on the chart below, from the St. Louis Federal Reserve bank, this is up from less than $1.5 trillion in 1980.

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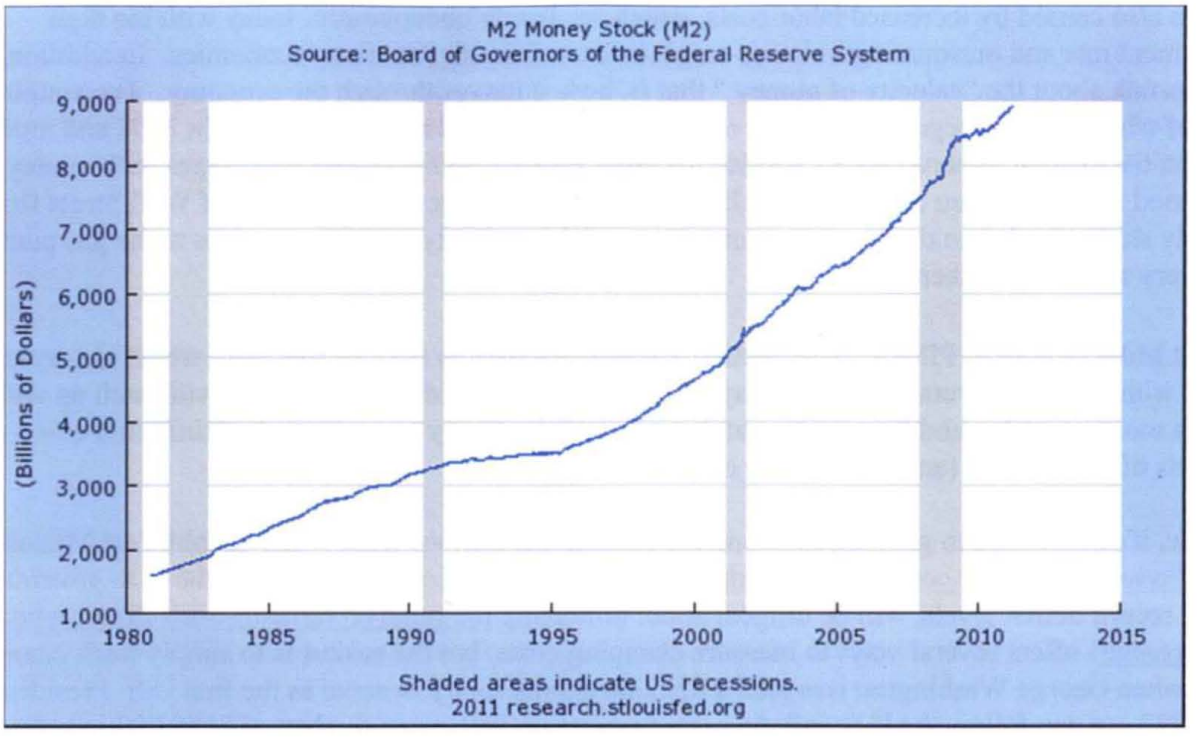
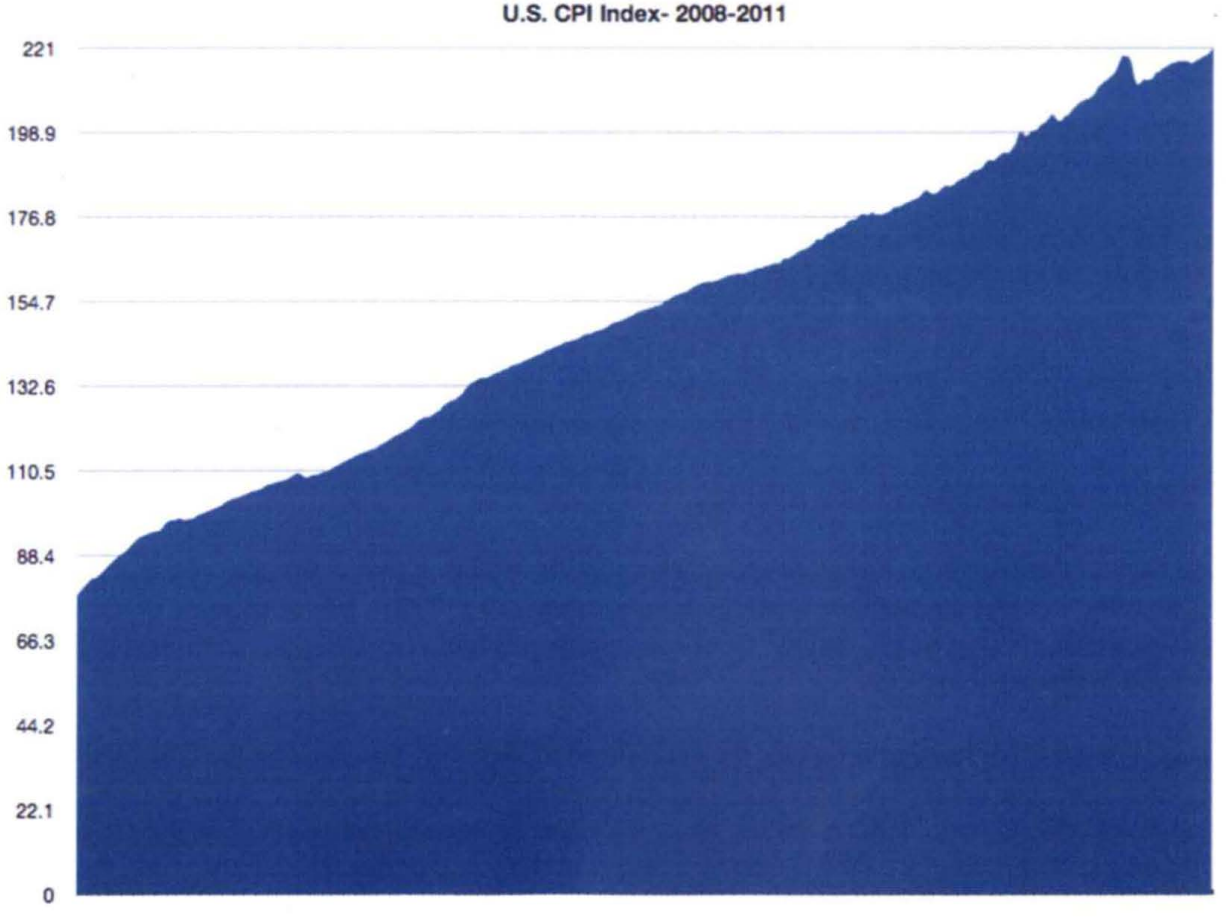


However, the relationship between the supply of money and future inflation is a bit more complicated than just projecting prices to go up along the same line as money supply. The chart below shows the trend of the value of a dollar since 1980, using data from the St. Louis Fed web site; as you can see; inflation has not risen quite as steeply as the money supply these last 30 years.



Inflation is also caused by increased labor costs, which are firmly under control today with the high unemployment rate and outsourcing to lower-wage Asian and South American economies. In addition, economists talk about the "velocity of money;" that is, how it moves through the economy. The simplest example of why a low (or negative) velocity of money can block inflation can be seen in 2008 and much of 2009, when the Federal Reserve Board flooded the large investment banks and brokerages with money, but the banks refused to lend it. You can stuff an unlimited number of dollars in the pockets of Wall Street firms, but if they simply stuff it back into their own pockets, the result is not likely to drive up prices at the gas pump, the mall, grocery store or anywhere else.

Economist Mihir Worah of PIMCO is projecting 1% to 1.5% rises in the CPI this year, which is very modest compared with historical averages. But he says that eventually the velocity of money will catch up with the increase in money supply--and then, well, watch out, because nobody knows how high inflation could rise or the interests of its creditors (and those living on fixed incomes).

Meanwhile, it's interesting to go back and compare costs in the past vs. today. The WealthVest Marketing web site (http://www.wealthvest.com/blog/wade-dokken/seven-ways-to-compute- whether the U.S. government, looking at record deficit levels, will be diligent about protecting the-relative-value-of-a-u-s-dollar-amount-1774-to-present/) offers several ways to measure changing costs, but the easiest is to simply track changes in the CPI. So when George Washington was paid a $25,000 annual salary to serve as the first U.S. President from 1789 to 1797, we can follow the U.S. inflation rate to come up with an equivalent of $585,000 in today's dollars--not far from the $400,000 salary that President Obama is paid.

But not everything has kept pace with the rate of inflation. In 1925, a brand new Model T Ford automobile cost $290. That would equal $3,500 in today's prices--about half the down payment you'll probably pay for a new Lexus coupe. In 1930 and 1931, the Yankees slugger Babe Ruth earned an annual salary of $80,000--the equivalent of about $1 million a year today, or about what the .214 hitter sitting at the far end of the bench makes for the Yankees today.

The Unexpected Recovery

Did you know that the Internet can now read minds? Here's the proof: http://www.youtube.com/watch?v=Hc1WXBtum2o&feature=related.

Last week, the world celebrated an unusual two-year anniversary: 24 months from the low point in the global markets, the point of maximum pain and panic following the 2008 economic meltdown and so-called Great Recession.

On March 9, 2009, the S&P 500 had fallen to its low of 676, which is about where it had been in October of 1996--13 years before. Since then, the S&P index has gone up about 95%, bringing it within 15% of its record high in 2007. The Russell 2000 index, which tracks small cap stocks, has gone up 140% in the same period, and the MSCI Emerging Markets Index is up 122%.

If you look back at the economic forecasts and market reports in March two years ago, you don't find, anywhere, a prediction that the markets would recover as they have. There was even some doubt whether the U.S. economy would survive intact, and the most common prediction was deflation, continued recession and more downside in the stock markets.

In retrospect, this most frightening time was the ideal times to shove all the chips on the table and bet everything on a stock market recover--but who had the intestinal fortitude for that? After the losses that virtually all investors had sustained, no matter where they had deployed their assets, few had the stomach, or the heart, to bet on a robust recovery. This is a terrific lesson in the value of disciplined investing; the consensus

and our own gut feelings are often wrong and inevitably point us in the opposite direction from where the returns are going to come from next. In the past, every long-term upturn has been greater than the losses sustained in the prior bear market. We don't know how this one will end, but it seems to be following the same seemingly unlikely, but not unusual, course.

The Tsunami's global impact

We're all hearing about the tragedy in Japan, with horrific photos and video footage of the aftermath of the earthquake and 10-meter Tsunami. The humanitarian disaster, with thousands dead and tens of thousands homeless, will continue to capture the world's attention. If you can bear to look, here's some remarkable Japanese TV footage of the tsunami roaring into the Japanese coastline: http://www.youtube.com/watch?v=TRDpTEjumdo.

But what impact will the disaster have on the global economy and investment portfolios? Japanese stocks fell 6.2% on Monday after a 1.72% drop on Friday. While significant, this decline is actually less than the 7.5% decline that followed the 1995 Kobe earthquake. London's Guardian newspaper reported that the Bank of Japan injected 21.8 trillion yen ($266.9 billion) into the Japanese economy, as a measure to limit the financial devastation wreaked by the crisis.

The hardest-hit Japanese stock is likely to be Tokyo Electric Power Company, which has had to close power plants and is fighting core meltdowns in three nuclear facilities. Toyota, which is now the world's largest car maker, has announced that it will close 12 assembly plants across the country until at least Wednesday night, causing $72 million a day in losses.

The disaster also had a counterintuitive impact on global oil prices; crude prices actually fell 3% on Friday and slid further on Monday as analysts expected lower demand in the short-term from the world's third-largest oil consumer. Longer-term, prices could be pushed up. Japan typically receives about a third of its energy from nuclear power, but its power capacity fell by more than one-fifth as 11 reactors went off-line. Japan may be bidding against the world for oil supplies, since oil and gas are the most plausible energy replacements to its nuclear generators. Of course the additional demand comes as Libyan oil fields have come off-line.

How the disaster will affect other countries is uncertain. U.S. shares fell 1%, and European shares dropped 1.5% on Monday, but the U.S. News & World Report web site quoted several international economists who believe that the damage is unlikely to spread, and who expect the high-savings Japanese to rebuild quickly and efficiently. The Japanese do hold about 10% of U.S. government debt, so if the Japanese decide to repatriate funds to pay for a massive cleanup and rebuilding effort, it could raise government bond rates.

The U.S. News & World Report analysis further speculated that the Japanese auto industry may have to temporarily curtail shipments of the Toyota Yaris, Scion xD and xB, Honda CR-V, Accord and Fit and Acura TSX and RL. Dealer networks normally carry a 30-day supply of autos, so the shortage won't become immediately apparent; a bigger issue is whether Japanese auto makers will be able to find replacements for the parts suppliers whose factories were destroyed, and whether U.S.-made models will suffer from a shortage of parts shipped from Japan.

Japan Update

The news from Japan should, first and foremost, be viewed as a human tragedy of horrific proportions, and we extend our blessings and sympathy to the people affected by the earthquake, tsunami and nuclear reactor crises in Fukushima. People from around the U.S. are pledging support for the humanitarian efforts. Perhaps the easiest way to get support quickly is to dial the Red Cross by typing in 90999 on your cell phone or

1-800-RED-CROSS on a regular phone line, or go to the web site at www.redcross.org. Reports say that the Japanese chapter of the Red Cross is one of the best organized in the world.

Other possibilities are the International Rescue Committee (http://www.rescue.org/), AmeriCares (https://secure.americares.org/site/Donation2?df_id=1503&1503.donation=form1) and UNICEF (https://secure.unicefusa.org/site/Donation2?idb=1639082129&df_id=1661&1661.donation=form1).

The economic impact of this tragedy is much harder to gauge. As you have no doubt read, the 6% drop in the Japanese stock market on Monday was followed by an 11% drop on Tuesday—the largest two-day decline in 40 years. But Wednesday trading saw a remarkable 5.7% increase, proving once again that the markets tend to overreact to shocking events, giving savvy investors a chance to buy shares at a bargain. Shares of Toyota gained 9.1% on the day, SONY Corp. was up 8.8% and Isuzu Motors closed 10.5% higher—the kind of gains that we normally associate with a year of trading.

Disruptions also spread pain and opportunity disproportionately among the corporations on the scene. Japanese insurance companies NKSJ and MS&AD are likely to have direct exposure to earthquake-related property losses, but some of their losses will be absorbed by the government-sponsored Japan Earthquake Reinsurance Company and private reinsurance arrangements. Similarly, Japanese construction companies will almost certainly see a windfall of business, which may be why Nishimatsu Construction Co. share prices rose 5.8% and Kobe Steel was up a remarkable 15% in Wednesday's trading. At the same time, there is likely to be a chill in global construction of nuclear power facilities, while governments and communities assess safety measures already in place.

Will U.S. citizens face any danger from the fallout from nuclear reactors? Over the next week, you'll hear exaggerated estimates of the danger. The latest news reports say that low levels of radiation have been detected as far away as 200 miles from the nuclear plant, but the radioactivity that has been released into the atmosphere appears to be coming from a storage pond that caught fire (since extinguished) where fuel rods are kept cool. This is not a nuclear explosion, and it is helpful to remember that Seattle—the nearest city to northern Japan—is 4,792 miles away from the potential meltdown sites, or about a fifth of the circumference of the Earth.

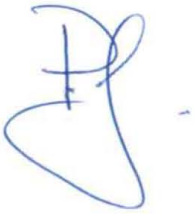
Those of a certain age may remember when Soviet Russia set off a 50-megaton hydrogen bomb 4,000 meters (13,000 feet) over the Arctic island of Novaya Zemlya in far northern Siberia on October 30, 1961, at a time when prevailing winds were reportedly blowing over the North Pole toward Canada. The blast, which shattered windows as far away as Norway and Finland, threw up many many orders of magnitude more radiation than exists in the Japanese core reactors, and it was much closer to the U.S. mainland than is Fukushima Dai-ichi. The subsequent evaluation of Russia's political stunt was that the detonation was extremely unwise, but the only health concerns it raised were warnings that children should avoid eating the snow. A Wikipedia article on the Chernobyl meltdown (a far greater disaster in terms of spread of radiation) suggests that there were moderate health impacts in France, the Czech Republic and, of course, Belarus and the Ukraine, but not on other continents.

As you continue to see images from Japan, recognize that we are all exposed to some risk of tragedy. There are steps you can take to minimize the personal damage: review and update your property and casualty/homeowners policy, have a reserve of cash, create a family emergency plan, and keep your investment portfolio diversified enough so that a major incident somewhere in the world has a very small effect on your overall holdings.

DFA Named #1 Mutual Fund Company in 2010 by Barron's

I have enclosed a copy of the Barron's article naming Dimensional Fund Advisors (DFA) as the #1 mutual fund company of 2010. DFA was rewarded for their: strategy, discipline, and structure in winning this notable acknowledgement. Stock market efficiency coupled with DFA's commitment to market, value, and size premiums has allowed them to consistently outperform the averages.

Sincerely,



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PJD/tst

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Two straight years of strong returns have made fund investors more comfortable with risk. Just don't get too comfortable.

That's Better Now

By Michael Shari Investment success last year meant embracing risk. Certainly, it wasn't hard to find. • Following 2009's sharp rally, investors had to confront their fears about weak U.S. housing and employment, Europe's ugly sovereign balance sheets, May's violent flash crash, a sharp swing in U.S. political sentiment, deficit-ridden state and local governments and the effects of easy U.S. monetary policy in order to partake in a second-half stock-market surge that many reasonable people mistrusted. Risk was rewarded. • In such an unpredictable year, the mutual-fund families that delivered the best overall returns for their shareholders didn't take money off the table, flee to defensive stocks or hide in Treasury bonds. That made for some unusual winners in our annual ranking of the best fund families. A prime example is the leader of the *Barron's*/Lipper ranking: Dimensional Fund Advisors, a quantitative-fund group with many index-like qualities. DFA was followed by Nuveen Fund Advisors, newcomer Principal Management, Oppenheimer Funds, and Waddell & Reed Investment Management (see table, page 30). • Overall, they topped their rivals with strong returns in areas like emerging-market stocks, which were up 19.54%, small-and mid-cap growth and value plays, which gained 27.7% and 24.19%, respectively, and global high-yield funds, which rose about 3.50%, according to Lipper. • "At the highest level, it would come down to the amount of risk a fund manager took.

In general, riskier assets, lower credit quality and lower-quality companies generally outperformed less risky assets across equity, fixed income and various asset classes," says Jeremy Degroot, chief investment officer of Litman/Gregory, a firm that specializes in mutual-fund research in Orinda, California.

The strong gains have put money in the pockets of fund shareholders and the funds themselves. Publicly help **T. Rowe Price** (ticker: TROW) saw its earnings per share increase 50.2% in 2010, to $2.47, according to Keefe, Bruyette & Woods; they are expected to rise another 17.5% this year. **Waddell & Reed** (WDR) posted a 45.7% rise to $1.80 a share in 2010 profit; earnings are seen increasing by 16.7% for 2011. **Janus** (JNS), **Legg Mason** (LM), **Franklin Resources** (BEN) and **Invesco** (IVZ) all reported healthy profits, through some of them might have hoped for better investment returns.

Can mutual-fund families and their investors continue to dodge the raindrops for another year? Not only are the stocks at higher levels and bond yields still low, none of 2010's risks have disappeared and a new one-political upheaval across the Mideast and North Africa- has appeared. The unrest in Egypt and elsewhere is a challenge for big oil companies that depend on the region for much of their supply, says Henry Herrmann, CEO of Waddell & Reed. And the worries about U.S. states and municipalities have worsened of late, driving $13.37 billion out of municipal-bond funds in December, a trend Degroot warns could continue.

"This could be the trend in the year ahead-risk on, risk off-with people thinking 'the world is coming to an end' or 'maybe I'm missing the trend,'" observes Degroot.

Possibly a little late, retail investors seem to be getting their courage up to wade into U.S. stocks again. From Jan. 1 to Jan. 26 of the New Year, $11.82 billion flowed into U.S. large-cap growth and value equity funds, more than triple the $2.82 billion that went into international stock funds, according to Lipper. In 2010, $74.88 billion flowed out of U.S. stock funds, while $42.71 billion came into international stock funds, and a gargantuan $213.25 billion poured into taxable-bond funds.

Not everyone agrees that risk levels are rising: "The risky stuff is more stable this year," says Art Steinmetz, chief investment officer of Oppenheimer.

Of course, it's impossible to time stock-and bond-market changes and the strategy that's paid off for the best big fund families-as well as investors- is a diversified one. Our No. 1, DFA, is a global asset manager that oversees $206.5 billion in all and owns a mind-boggling 13,000 stocks, or about 70% of the world's publicly listed equities. Because DFA's investment process is purely quantitative, it doesn't have the option of succumbing to fear in the face of adversity. It certainly helped that DFA focuses much of its attention on some of last year's highest-performing equity areas-value, small-cap and emerging markets.

"What was important last year was to stay fully invested," explains David Booth, chief executive and cofounder of DFA. "We take diversification very seriously. We tend to be more global than other fund families. We emphasize small-cap and value stocks globally, and in emerging markets. Those factors paid off last year."

The privately held firm (Arnold Schwarzenegger is an investor) also is known for keeping a lid on costs that can rob shareholders of performance points, steering clear of some foreign markets where it doesn't believe funds can get a fair shake on prices. DFA's strong equity performance carried the day: It finished first in U.S. equities, 13th in world equities and 5th in mixed equities last year, according to Lipper.

Our survey weights each category of fund differently: 40.52% for U.S. equity, 14.32% for world equity, 16.46% for mixed equity, 24.52% for taxable bonds and 4.18% for tax-exempt bonds. (For our complete methodology, see Barrons.com)

The stresses caused by the financial crisis as well as the mutual-fund industry's never-ending quest for scale continues to prompt consolidation. Morgan Stanley has sold most of its Van Kampen unit to Invesco, Prudential absorbed JennisonDryden under its own brand and Wells Fargo took Evergreen under its wing.

One beneficiary was Nuveen, which picked up FAF Advisors, a strong performer in *Barron's* previous rankings. Nuveen, best known for its bond expertise, particularly in tax-exempts, has added to its skills in both U.S. and foreign equities. With pretty good strength across the board, particularly in equities, Nuveen is No.2 for 2010.

The theme that drove returns in domestic equity last year was "the return of U.S. consumer," says Tom Schreier, the former CEO of FAF who is now vice chairman of Nuveen. Those funds that picked stocks that were poised to benefit from added consumer spending did well. The $1 billion **Nuveen Equity Income** Fund