

# International Allocation Views

October 20, 2006

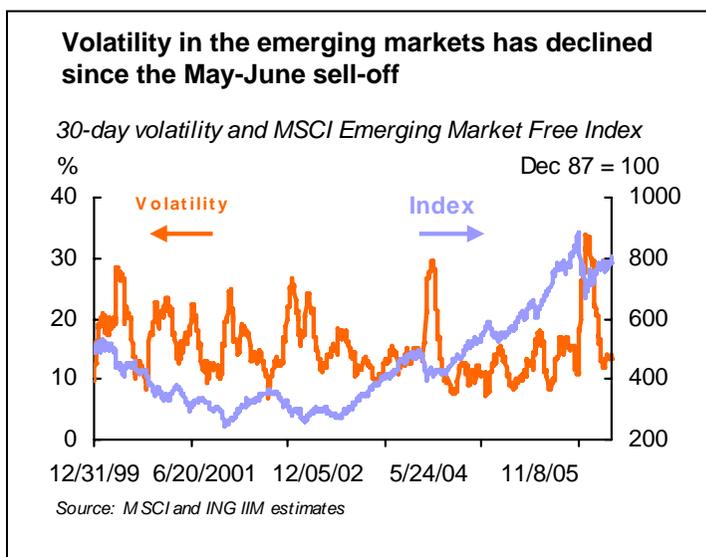
- This month, we are raising our allocation to emerging markets, to large-cap value stocks in the developed markets, and to international REITs. Despite these moves we are still underweighted in emerging market and large-cap value stocks, though we are now up to neutral in REITs.
- Volatility in the emerging markets has fallen recently, and flows into emerging market equity mutual funds have begun to stabilize, pointing to a more hospitable climate for those markets. Accordingly, we are raising our allocation to emerging market funds, though remaining modestly underweighted. Enough uncertainty still exists about the global outlook to warrant some caution.
- While we continue to favor growth stocks in the large-cap universe, we are raising our allocation to international value stocks. Our international fund managers are finding some bargains among value stocks, and need to make room to buy them by lightening up on growth stocks.
- In July we added international real estate investment trusts (REITs) as an asset class, with an initial underweighting. This month we are moving our REIT position to neutral. Moderate growth abroad and still-low interest rates are favorable for REITs, and valuations are, by some measures, still attractive in several markets. We would like to have a substantial allocation to REITs for diversification purposes and believe this is a reasonable entry point.

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Current Positions			
	Neutral (%)	Recommended Allocation	Change from Last Month
<b>Large-Cap Developed Markets</b>			
EAFE core stocks	40	Overweight	Unchanged
EAFE growth stocks	15	Overweight	Reduced
EAFE value stocks	15	Underweight	Unchanged
<i>Total large-cap</i>	<i>70</i>		
<b>Small-Cap Developed Markets</b>			
EAFE small-cap stocks	10	Underweight	Reduced
<b>Emerging Markets</b>			
Emerging market stocks	17	Underweight	Raised
<b>International Real Estate</b>			
International REITs	3	Neutral	Raised



This report does not make any recommendation about your investments, and this information should not be considered investment advice. Any opinions expressed herein reflect our judgment at this date and are subject to change.

Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels and (4) increasing levels of loan defaults.

**Reducing our Defensive Position in International Equities**

In late May, in the midst of a sharp, correlated downturn in global equity and commodity markets, we moved to reduce risk in our portfolios by underweighting developed-market small-caps and the emerging markets. Although the markets have rallied since then, we stayed underweighted in those asset classes on a concern that they would underperform in a global environment of decelerating growth and less liquidity. In recent weeks, however, evidence has appeared that the global slowdown is likely to be mild, and that global inflation may remain under control. Moreover, valuations in the emerging markets, which had been close to their all-time highs in May, are now lower. In addition, volatility in the emerging markets has subsided, flows into emerging market equity funds have begun to stabilize – both good signs for future performance. Taken together, these developments, in our view, warrant a less defensive stance, which we have adopted by raising our allocation to emerging markets, though not all the way up to our fairly aggressive strategic neutral of 17% of the portfolio. Why not a more aggressive stance? Because there is still some risk that the global economy will decelerate by more than we expect, possibly because central banks around the world are not as close to being finished with their monetary tightening.

**Raising our international REIT Allocation to Neutral**

In July we added REITs to our international portfolios, but underweighted them relative to their strategic neutral allocation of 3%. We have long wanted to add REITs because their return-risk performance has been attractive, and because correlation of their returns with those on international equities suggest material diversification benefits. We were reluctant to add them at an overweighted or neutral weighting, however, because most central banks around the world were still hiking interest rates, which raised the prospect of a global downturn in growth. REITs had outperformed international equities for over five years, and we did not want to be buying near the peak. Since then our concerns have abated. First, the Federal Reserve has paused in its tightening, and in our view will be on hold for several months. This means less upward pressure on global interest rates as borrowers compete for funding worldwide. Second, the global economy is showing signs of resilience in the face of earlier evidence, such as a downturn in leading indicators, that pointed to slower growth. Low interest rates and moderate growth are favorable for REITs. While REITs are trading at a premium to NAV in some markets, they are trading at a discount in others. Taken together, these considerations suggest that raising the allocation to REITs, to neutral but not beyond, is appropriate. We have financed the move to neutral by reducing our allocation to small caps, to which REIT returns are highly correlated.

