

2012 Commonfund Outlook

Economic and Capital Market
Commentary

January 9, 2012



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Editors Note

This update to 2012 global economic update reflects a slightly more optimistic perspective than that which we originally published in January. While our overall view remains consistent, we have increased our estimate of U.S. GDP growth from 2.3 percent to 2.5 percent, and have raised our year-end return estimate for the S&P 500 index (ex-dividends) from 6.6 percent to 10.2 percent. Tail risks remain unchanged, and saber rattling in Iran is an increased concern. However, the outlook for the U.S. economy is stronger today than two months ago, based on improving labor conditions and continued strong corporate earnings. *Updated: March 2012*

About Commonfund

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Commonfund 2012 Global Economic and Investment Outlook

This report presents Commonfund's 2012 outlook, point of view and broad themes that will shape our investment strategies and positioning over the next year.

As we begin 2012, the global economic and investment environment faces a significant secular shift with emerging markets transitioning to domestic-oriented, consumer economies, and with developed economies facing the burden of massive sovereign debt, deficits and the need for dramatic fiscal restraint. Stimulus in the form of monetary easing and government spending has for some time, put off the day of reckoning for Europe and the U.S. while supporting risk assets – and at times providing a healthy tail wind. For 2012 we expect little policy change to remove liquidity from the system, yet there is increased government execution risk globally from elections in the U.S., Europe, China and elsewhere. So what does this mean for the long-term minded institutional investor? In our view, and as presented on the pages which follow, this environment calls for a heightened sensitivity to valuations and to strategies that mitigate tail risks. So while we begin the year relatively neutral in our strategies on a broadly defined asset basis we see a range of opportunities for active managers to provide investor value.

Today, the concerns that have rattled global financial markets since last spring largely remain:

- Will the U.S. be able to sustain a level of reasonable growth?
- Can China achieve a “soft landing” and continue to be an engine of global growth?
- Will the debt problems that plague the EU be handled in an orderly process, or will they dramatically disrupt European economies?

For most economists and investment strategists, the performance of the global capital markets will hinge on Europe, and we clearly view a disruptive collapse of the EU as the most significant systemic risk facing the markets in 2012. And while we place a higher than historical probability on a doomsday scenario for Europe, we are somewhat more sanguine than consensus and instead see some hopeful signs of central bankers in Europe, the U.S. and Asia working together to prevent a meltdown of the European Union, particularly in the liquidity providing ECB loan program. This doesn't mean that Europe is not without significant risk, and indeed we expect rolling recessions to occur across the continent in 2012 and into 2013.

In the U.S., we are also somewhat more optimistic than the consensus view on the outlook for the U.S. economy. Fourth quarter data in 2011 portends greater, and we believe more sustainable growth prospects for 2012, with real GDP growing at about 2.5 percent over the next 12 months. Further, we believe that there is greater upside opportunity for growth in the U.S. than there is downside risk.

Still, China and the emerging markets are likely to be the engines of global growth for the coming year. While emerging market equities suffered dramatically in 2011 – with China alone down 22 percent – the twin drivers of weak performance (a slowdown in economic growth and high inflation) are not likely to repeat for 2012. Inflation is down significantly and with it, we expect monetary policy easing in China this year and thus a “soft landing” and economic growth in China ranging from 7-8 percent.

Before expanding upon these themes and their likely impact on world financial markets, it is important to look back briefly at 2011, where we began, where we ended and the driving factors.

Looking Back at 2011

The S&P 500 began calendar year 2011 at 1257. Two hundred and fifty two trading days later – and after revolutions and unrest across the Arab world, a devastating earthquake and tsunami in Japan, a downgrade of U.S. Treasuries and the collapse of several European governments – the S&P 500 finished the year at...1257.

We began 2011 with a generally positive view towards both the U.S. economy and the capital markets, and this was strongly reflected in the performance of U.S. equity markets over the first four months of the year, with the S&P gaining nearly 9 percent by late April. At about this time, however, we began to see some signs that that the market euphoria might be overdone:

- The sovereign debt crisis in Europe was reaching a breaking point;
- Aggressive monetary policy tightening in the emerging markets to stave off inflationary pressures was dampening economic activity; and
- A spike in energy costs was putting a struggling U.S. economy at increased risk.

A year ago, we placed a 20 percent risk for such a “stress scenario” – that a combination of input cost inflation pressures and the sovereign debt crisis could become the dominating factors limiting world growth to 4 percent and U.S. growth to 2 percent. Accordingly, if realized, this downside risk forecast could fuel a reacceleration of inflation, a correction in the S&P 500 Index towards 1150, and a “flight-to-quality” rally lowering the yield of 10-year notes to 2.5 percent.

As it played out, geopolitical unrest in MENA (and an associated temporary spike in oil prices), supply channel problems in Japan, debt challenges in continental Europe and the U.S., and fears of a hard landing in China following aggressive tightening moves to fight inflation, fueled a sharp waterfall sell-off in the equity markets last summer, making our 20 percent “stress scenario” forecast a harsh reality. Following the waterfall sell-off, the domestic stock market quickly recovered about one-

half of the losses and then spent the bulk of the final months of 2011 within a volatile 10 percent trading range that was between 1120 and 1230 for the S&P 500 Index.

Despite the fiscal challenges domestically and even more so in Europe, where Greece and several of the southern European countries’ economic/financial market problems have been headline dominating events, the U.S. stock market separated a bit from the problems in Europe during the fall of 2011. Since Labor Day, a series of stronger domestic economic readings for private employment, discretionary consumer spending, industrial output, and construction activity, helped to boost the S&P 500 Index 11.8 percent in Q4 2011 to finish the year at 1257.6, virtually unchanged from a year ago. In contrast, stocks in Italy plummeted about 25 percent during the year, while the major equity markets in France and Germany fell 17 percent and 14.7 percent, respectively. The British market held in a bit better than its continental European neighbors, as the FTSE fell 5.6 percent. In Asia, the dual concern about a slowdown in economic growth and higher inflation fueled a 22 percent decline in China’s stock market, but a peaking in inflation in China, combined with an easing in reserve requirements, could be a hint that the tide is turning in China as we head into this year. This “de-coupling” of returns across the three regions has implications for 2012 positioning.

2012 Themes Driving the Global Economy

The drivers of the capital markets for 2012 are largely the key themes that we believe will define the global economy, and direct our strategies and positioning in the year ahead:

- U.S. Growth
- China’s Soft Landing
- Europe’s Challenges

In the context of these themes we have outlined five economic scenarios for 2012, and have represented them as a distribution of possible outcomes.

Scenario	Likelihood	
	Jan 2012	Mar 2012
Core	50 percent	43 percent
Strong U.S. Growth	20 percent	30 percent
U.S. Growth Challenged	15 percent	12 percent
Eurozone/Middle East Disaster	10 percent	10 percent
European Solution	5 percent	5 percent

In formulating our projections for the year, we calculated a weighted average of each of these five scenarios to use this as our baseline overall forecast. Thus, our weighted average forecast for 2012 is for 2.5 percent real GDP growth in the U.S., a moderate -0.3 percent recession in Europe, a backup in 10-year Treasury note yields to 2.7 percent, and a rise in S&P 500 earnings to \$105 (on a top down basis). We are assuming a slight expansion in the P/E multiple to 13.2, which if realized

Table I

Scenario Analysis and Projections for 2012

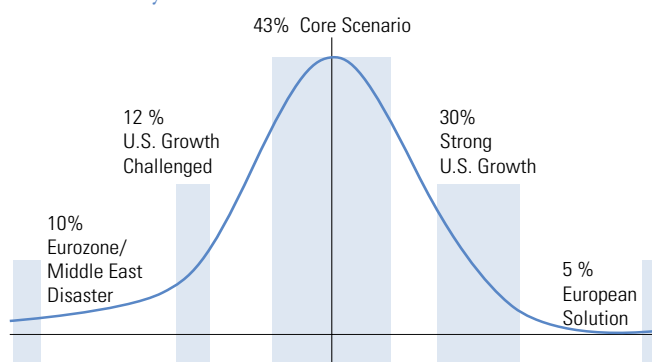
Scenario	Probability	GDP US	GDP Europe	US Un-employment Rate	10-Year Note Yield	Earnings Growth Rate	S&P 500 Earnings (\$)	S&P 500 P/E Multiple	S&P 500 Index Level
Eurozone/Middle East Disaster	10%	-1.0%	-3.0%	9.5%	1.25%	-18%	80	11.5	924
U.S. Growth Challenged	12%	1.2%	-1.5%	8.8%	1.50%	-4%	94	12.3	1157
Core Scenario	43%	2.7%	-0.3%	8.0%	2.75%	8%	106	13.3	1410
Strong U.S. Growth	30%	3.5%	0.7%	7.2%	3.25%	15%	113	13.7	1544
European Solution	5%	4.5%	2.0%	6.8%	4.25%	21%	119	14.0	1660
Weighted Average	100%	2.5%	-0.3%	7.9%	2.7%	6.7%	105	13.2	1385

could boost the S&P 500 Index to 1385 this year, representing a 10.2 percent increase over year-end 2011 levels (with a total return of about 12.5 percent including dividends).

Our core scenario, for which we attach a 43 percent probability, forecasts the U.S. economy to expand by 2.7 percent and the S&P 500 Index to return 12.2 percent (approximately 14.5 percent including dividends). In this scenario we expect the yield on 10-year U.S. Treasury notes to increase from the current level of about two percent to 2.75 percent. And, we forecast negative real GDP growth in Europe of -0.3 percent.

Our scenario modeling is not a normal distribution, and is instead marked by “fatter tails” and less conviction in our core scenario – evidence of strong systemic risks in the world economies. On the risk side, we attach a ten percent possibility of what we call a “Eurozone/Middle East disaster,” defined as a disruptive breakup of the EU, a deep contraction of economic activity in the Eurozone (-3.0 percent real GDP) and a mild recession in the U.S. as well as in several other regions. Under this doomsday scenario, the unemployment rate would increase sharply to 9.7 percent, the flight-to-quality rally in U.S. Treasuries would continue, credit spreads would increase, while corporate earnings would plunge at a double digit pace. We would also look for P/E multiples to contract and for equity prices to weaken dramatically. Although the latest deal on Greece is a positive development, heightened tensions associated with the events in Iran have increased the risk factors for a bad event in the Middle East.

Scenario Analysis 2012



On the right tail or positive side of our distribution, we place just a five percent likelihood of a true European solution, which would be marketed by dramatic infusions of liquidity and capital by the ECB to the European banking system. Should this – highly unlikely – scenario happen, Europe would achieve modest growth and in part as a consequence, U.S. economic growth we forecast would expand by more than four percent and U.S. equities would likely increase more than 30 percent.

The accompanying table above more fully presents our scenario analysis and latest projections for 2012 and the following sections provide more context to our three core themes.

The unusually wide dispersion of the five alternative scenarios that are displayed reflect the greater challenges that the U.S., Europe, and the world are currently facing economically and geopolitically, as well as the added concern for a developed world that has become way too dependent on low cost debt.

Theme #1 - U.S. Growth

Record corporate cash balances, strong profits, solid demand for U.S. products, technology, and services from the emerging markets, low inventory positions, and favorable investment tax incentives for business spending should produce solid gains in the industrial and business investment sectors of the economy. Moreover, the moderation in energy prices (specifically natural gas) from the spike earlier this year, the sharp reduction in consumer debt service costs, the easing of supply channel disruptions associated with the earthquake and nuclear disaster in Japan, and a rebound in domestic homebuilding activity boosted real GDP growth towards 3 percent in 2011 Q4. Moreover, these events may provide a positive feedback loop for economic activity in the early stages of 2012. Accordingly, we look for real economic activity in the U.S. to expand at a mid two percent pace in 2012.

In recent months, the employment and housing statistics have both come in significantly stronger than market participants and economists had anticipated, suggesting that the domestic economy could be entering a self-sustaining phase with a positive feedback loop. Although the government sector has

been and will likely continue to be a drag on economic activity for the next several months and years, private sector economic activity has improved. This has been most noticeable on the labor front.

Nonfarm payroll employment rose by 200,000 in December 2011, with 212,000 net new jobs in the private sector, while the household series revealed an unexpected 0.2 percentage point drop in the civilian unemployment rate to 8.5 percent. Both the number of unemployed persons (13.1 million) and the unemployment rate (8.5 percent) continued to trend down in December. The unemployment rate has now declined by 0.6 percentage points since August.

Likewise, in the housing sector, better readings are unfolding that could provide hidden support to residential investment activity as well as construction-related employment. This could provide a hidden boost to real GDP growth and help to stabilize prices in the housing industry. Housing starts in November surged 9.3 percent to a 685,000 unit rate, from a revised 627,000 pace in October, while building permits rose 5.7 percent to a 681,000 unit rate. A substantial portion of this strength was in the multi-family sector, possibly reflecting a favorable response to the reality that rents have been rising, improving the economics of rental properties in the process. However, at the same time single-family activity has received support from the highest housing affordability readings on record.

On a year-over-year basis CPI is now accelerating at a 3.4 percent pace and core inflation has increased from a yearly pace of less than one percent to 2.2 percent. At this juncture, headline inflation is peaking, but core inflation is likely to gravitate at or near the two percent area over the near term. Internationally, we believe that the worst of the input cost inflation pressure in the emerging economies is largely behind us (with the possible exception of India). However, the events in the Middle East, especially Iran, are unstable and the global economy is vulnerable to a spike in oil prices should a bad event unfold. In particular, discretionary consumer spending in the U.S. could be hurt if gasoline prices move to and stay above the \$4 per gallon level. Barring problems in the oil complex, a deceleration in the rate of increase for food costs, combined with slight slower economic growth and currency adjustments, should help to temper headline inflation.

On the fixed income front, despite the implementation of a \$400 billion "operation twist" by the Fed, the greater long term risk to the U.S. Treasury market over the next several years is for higher rather than lower market interest rates. A year ago we stressed that the debt crisis in Europe represented one of the greatest risks to global economic activity. Today our worries include concerns about the U.S. debt burdens as well. Longer term we are still concerned that our own fiscal debt challenges in Washington will be a constraining factor on economic activity for the next several years. The upcom-

ing Presidential election, combined with potential changes to tax policies and tax rates, could provide additional volatility to both the economy and the capital markets. Moreover, the fiscal tax crunch that is currently set to unfold in 2013 is likely to become a major issue for both the economy and the capital markets as we approach the November 2012 elections.

Theme #2: China Soft Landing

Economic activity in the emerging markets has decelerated, but the emerging economies will still be the driver behind a modest 3.5 percent or so gain in world GDP growth in 2012. Real economic growth in China is likely to decelerate from more than 9 percent real growth towards the 7 percent to 8 percent level in 2012. However, when combined with a peaking in inflation, this will represent a soft landing for the Chinese economy that should open the door for a series of monetary policy easing actions by China.

Despite the deceleration in economic activity in China we will likely see a pick-up in consumer spending and a narrower trade surplus as the world's second largest economy shifts towards the development of a consumer-driven middle class. On balance, we look for emerging market economic activity to decelerate from a 7.4 percent pace in 2010 to about 5.5 percent in 2012. This slower growth, combined with a moderation in inflation, has already started to fuel an important reversal in monetary policy actions for many of the central banks in the developing world. The increased prospects for more aggressive easing in monetary policy, including an outright reduction in central bank targeted interest rates, should continue in 2012.

In China, consumer inflation peaked at 6.5 percent in the summer of 2011 and has now moderated to about a four percent yearly pace. This tempering in inflation, along with signs of a deceleration in economic activity, sparked the first of what will likely be several cuts in reserve requirements in China in late 2011. We look for China to continue to ease monetary policy in 2012 and for accommodative actions to include outright cuts in interest rates. As businesses and investors look to the future of China, the focus has changed from what can be outsourced to China at lower costs to what resources, products, and services can be delivered into China to meet the growing needs of its 1.3 billion consumers.

We believe that emerging equity markets will outperform the continental European markets over the next 12 months. As for China, we believe that the soft landing/lower inflation scenario has unfolded and this will open the door for more aggressive easing from the second largest country (on a GDP basis) in the world.

Theme #3: Europe's Challenges

In contrast, Europe will likely be challenged by a continuation of rolling recessions in the southern-European club-med countries and at best very weak growth in Germany. The net result should be a year of negative real GDP for Europe as the debt

crisis and the associated contraction in fiscal policy handcuffs economic activity. The sovereign debt crisis in southern Europe still represents the largest point of risk to global economic activity and the capital markets, and the decline in bank deposits in many of the southern European banks is a troubling event. Barring additional aggressive moves to address the debt crisis in southern Europe by both the ECB and individual governments, including a major expansion of the European Financial Stability Facility (EFSF), the sharp decline in activity in the southern European economies is likely to fuel a moderate outright decline in overall real GDP in continental Europe in the first half of 2012. Likewise, we look for the Euro to weaken another 10 percent or so to the 120 level versus the greenback in 2012.

The European Central Bank, citing their sole inflation-fighting mandate, implemented two ill-advised rate hikes in early 2011. Given the debt challenges in Europe and the structural economic weakness that is spreading like a cancer in Europe, the ECB finally recognized that a reversal in monetary policy was needed. Following the leadership change from Trichet to Draghi, two 25 basis point interest rate cuts were implemented by European leaders in the final quarter of 2011. The Europeans are still several chapters behind where they need to be in monetary policy and additional easing action will be needed in 2012.

It took until late December for the ECB to finally begin to implement aggressive quantitative easing. On December 21, the ECB awarded almost 500 billion euros (about \$650 billion USD) in three-year loans to banks in Europe. The financing rate will be the ECB's benchmark interest rate which is currently one percent. Several market participants were appropriately concerned that many more financial institutions are in trouble in Europe as 523 banks asked for funds. This "cheap" one percent money will allow the troubled banks in Europe to finance a portion of their challenging sovereign debt. However, with overleverage being a part of the problem in Europe, the benefit of a potential double down on a three year arbitrage bet to solve the problem of too much debt in Europe is risky. Nonetheless, this action if followed by additional measures in early 2012 will allow Europe to "kick the debt can" down the road. The program may also have a longer term benefit in providing a path to an orderly exit of certain countries from the Euro. Any break-up of the Euro creates an issue of how to treat cross-border debt. To the extent that national banks use loans under this facility to purchase their nation's sovereign debt, it makes parsing out the debt much easier, allowing each country to deal with the solvency issues of their own banks (in line with Merkel's statements). Whether this path is followed is less important than the fact a path exists, allowing investors to worry less about volatile reactions to the de-leveraging process. Unfortunately, the additional quantitative easing that may be needed from the ECB to keep liquidity in the European financial system could approach one trillion additional euros, with the next long-term refinancing operation (LTRO) pro-

gram likely to be implemented this month. Ultimately, Europe needs a real central bank with issuance authority, a unification of fiscal policies with penalties for those entities that cannot address their fiscal policy challenges, and a workout process to address the troubled debt.

The debt problems in Europe will likely continue to have an adverse impact on the capital markets in the upcoming year and, at times, will be a dominating factor in the financial markets. However, those touting a Doomsday scenario reminiscent of 2008 might be failing to recognize that many of the key central bankers in Europe, the U.S., and Asia appear to be working more closely together to do whatever they can to prevent Armageddon. If the Eurozone debt crisis can be contained to Europe, then the comparison with 1998, when the contagion stopped, could be more accurate than what unfolded in 2008. At this juncture in January 2012, market participants are anticipating that some of the "club med" countries are likely to either go through a major debt restructuring and/or leave the euro, with Greece and Portugal at the top of most lists. Moreover, it is widely anticipated that more financial institutions and countries in Europe will be downgraded by the ratings agencies. However, if this is done in an orderly process it might not be as disruptive over the longer term to the capital markets as many participants currently fear.

Strategies and Positioning

On a top line we believe that neutral weightings to policy portfolios for broadly defined equities and fixed income are appropriate; however, within these broad asset classes investors face very different opportunities, and we believe, return expectations over the next 12 months. Active management will be important in a market with elevated tail risk...and opportunities.

Equity Strategies

On the equity front, while carrying a neutral weight overall, we are underweight developed non-U.S. and overweight domestic and emerging markets. While valuations appear to be attractive (at 12x, 10x and 9x for U.S., EAFE and EM, respectively), near term risks regarding debt overhang and execution risk by governments, combined with longer term pressures on economic growth and earnings regardless of execution, lead to the underweight in Europe.

Emerging markets are favored over developed as economies are likely to de-couple a bit from Europe (moderate growth versus recession in Europe). This positioning also reflects greater near term geopolitical risk in Europe and a much better longer term growth story in the emerging markets, which should support both the public and private markets. The Euro is overvalued and could decline by 10 percent over the next 12 months to the 120 level as the ECB cuts rates or disintegration/downgrade fears weaken the Euro versus other currencies. Valuations in both the developed and especially in the emerging equity markets have dropped dramatically the last several months.

This may provide an opportunity for highly-skilled equity managers to buy good companies that are not directly exposed to the debt problems of Europe at favorable valuations.

Our philosophy in assessing opportunities and managing risk in this equity environment is as follows. First, we believe 2012 will be conducive for active managers unlike 2011 where macro events drove correlations to record levels and where volatility, and the risk-on, risk-off trading environment overwhelmed fundamentals. Second, we believe that the ability to value risk assets effectively will be rewarded, both in public and private markets. And, third, we believe that strategies that seek to reduce left tail risks, notably low volatility strategies, high dividend equities and hedge fund strategies, will be critical portfolio components.

Fixed Income Strategies

The current regime of very low absolute and relative interest rates in the U.S. is not sustainable over the long term and a possible reversal (“bursting of the U.S. Treasury bubble”) represents a substantial risk. Further, the inability of our government leaders to address this issue of overspending and revenue shortfalls represents a second major risk to both the economy and the capital markets, particularly if the bond vigilantes return to the U.S. Treasury market.

For the U.S., our debt situation is still at best challenging, and owning sub two percent 10-year Treasury notes for the next five years appears to represent a greater risk than owning high quality, dividend paying equities many of which trade at 10 to 25 percent below historical valuations. Our philosophy in fixed income for 2012 is as follows: First, maintain a very cautious exposure toward Treasury duration. Second, seek incremental yield through credit strategies and high grade corporate bonds. And, third, manage portfolio tail risk through strategies such as shorter-duration high yield paper, long/short credit and other relative value hedge fund strategies.

Inflation Hedging Strategies

While headline inflation in the U.S. is moderating and the risk of imported inflation has fallen, the sovereign debt crisis poses a longer term inflation risk if issuers seek to “reflate” their way to fiscal health. Inflation hedging strategies, including commodities, natural resources, real estate, and CTA hedge funds should be incorporated into a well-diversified portfolio to hedge against the risks for re-inflation and a bad event in the U.S. Treasury market. For example, several developed countries could experience a “crowding out” effect due to excessive dependency on debt which could dramatically raise issuance costs and fuel the seeds for a dangerous re-inflation test a few years from now.

Conclusions

If 2011 reminded us of anything it is that macro events can overwhelm market fundamentals, leading to market volatility and challenging risk-on, risk-off trading patterns. For 2012, we are mindful that events in the EU, as well as other geopolitical and systemic risk can likewise negate improving economic conditions – particularly in the U.S. and China. Certainly the risks to our core forecast are not symmetrical. Downside risk (debt problems that drastically hinder economic activity) is greater than the upside opportunity for robust growth and a double digit expansion in corporate profits next year.

Accordingly, we begin 2012 relatively neutral in our strategies overall, but prepared to add to defensive strategies should events in the EU worsen, or add to risk assets if growth prospects in the U.S. and China improve. Monitoring liquidity as well as solvency will be important.

The key event items to monitor in 2012 include the following:

- Europe and the southern European sovereign debt situation.
- Evaluating if the rebound in U.S. economic growth, employment, and housing activity in Q4 2011 is sustainable into 2012 and addressing the challenges that unfold associated with the elections this fall and our nation’s increased dependency on debt.
- Assessing the peaking inflation and the transition to a soft landing in China, as well as the associated rotation from monetary policy tightening to monetary policy accommodation.
- Analyzing the potential leadership changes in Europe, Asia, and the U.S., as well as the stability in the Middle East.

Market Commentary

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