

WORLD MARKET SURVEY

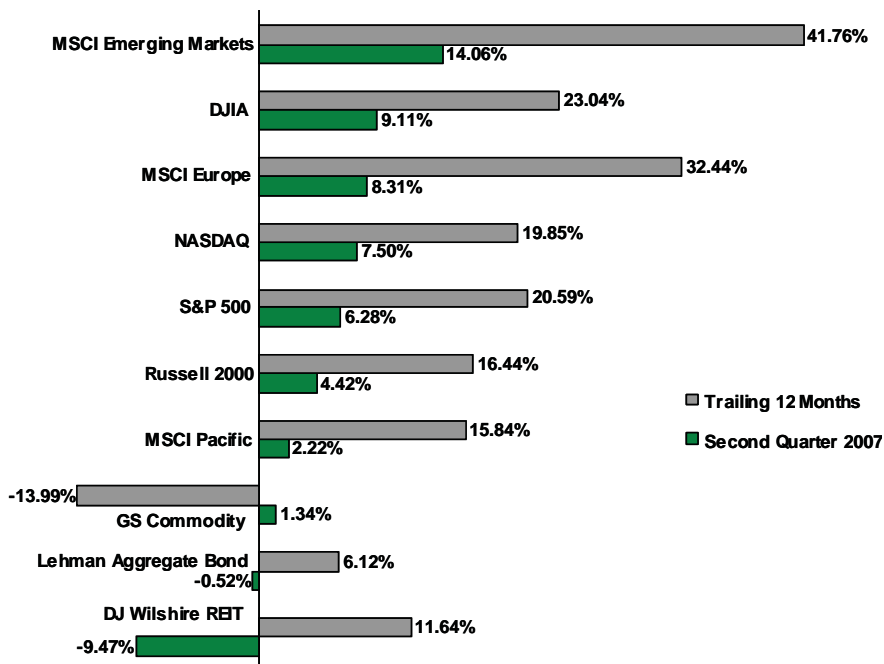
US Stocks

Despite the market's June swoon, returns from US stocks were positive for the second quarter. The Dow Jones Industrial Average gained 9.1% for the last three months and the S&P 500 Index was up 6.3%. On May 30, the S&P 500 finally surpassed its March 2000 peak, a recovery six years in the making. Returns from mid-sized and smaller company stocks were also positive for the quarter, although these returns lagged those of larger firms. The S&P Mid Cap 400 Index was up 5.8% and the Russell 2000 Index advanced 4.4%.

Results for the trailing twelve months were also impressive. The Russell 2000 gained 16.4% and the S&P Mid Cap 400 was up 18.5% for the year ending June 30. Returns on large cap stocks were better still, with the S&P 500 up 20.6% and the Dow

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Returns from Market Indices: Second Quarter 2007 & Trailing 12 Months



DOES SIZE MATTER? OPTIMAL SIZE FOR ACTIVELY MANAGED MUTUAL FUNDS

Is there an optimal size for actively managed mutual funds? Investors are often somewhat loath to commit significant sums to small, new funds with short histories, yet those who choose only well-established funds, with substantial assets under management and long track records, may miss out on the stellar returns often achieved by smaller, more nimble funds. Is there a way to resolve this conundrum?

This article is adapted from a longer paper written by SCLC principal Patrick Collins, "Without More: Trust Investment Manager Selection and Retention Policy," now available on our website. The paper explores many issues relating to investment prudence for trustees, among them this question of optimal fund size. Since it is difficult to argue that anyone should invest imprudently,

whether or not they are a fiduciary, the discussion is relevant to all investors.

Size Versus Performance

In theory, economies of scale should enable large funds to generate superior returns. All funds have operating costs such as support staff, computer systems, rent, etc.; large funds should be able to spread these fixed costs over a larger asset base. In addition, larger funds generally pay less per share traded, because broker/dealers discount their trading fees in exchange for trading volume. Finally, since funds that have consistently performed well should have attracted lots of investor dollars, it would seem that a large fund should, *ipso facto*, have a consistent history of above average returns.

However, reality seems to differ from theory. Since 1991, a series of studies have examined the relationship between an actively managed fund's size and its alpha – its returns in excess of a benchmark index. By examining historical returns using a variety of statistical techniques, the studies imply that large funds do not perform as well as their smaller brethren.

Recurring themes in these studies help explain why large funds underperform small funds:

- Despite the reduction in trading fees due to economies of scale, large funds incur higher overall trading costs due to the market impact of their large trades. As trading costs increase, alpha must also increase in order to

Successful funds with growing assets – funds that are in the process of becoming big – tend to drift away from the investment strategies that made them successful in the first place.

In a nutshell, as a fund grows, it faces increasingly unfavorable market conditions for the manager's trade orders.

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overcome them. A small fund that enjoys low market impact costs can afford to capture smaller alphas than a large fund. Trades that generate marginal alpha that is small, but nonetheless productive, are uneconomical for larger funds with high market impact costs. Failure to execute such trades is a major contributor to implementation shortfall – the manager cannot implement his good ideas in a real-world portfolio.

- Successful smaller funds – funds that are in the process of becoming big – tend to drift away from the investment strategies that made them successful in the first place.

Market Impact: More Costly Trading, Less Trading Overall

Why do larger funds have increased transaction costs despite their volume discounts on trading commissions? Institutional investors like mutual funds often trade in tranches large enough to change the market price of a security. *Market Impact Cost* is the difference between the transaction price at execution and the value of the security had the transaction not occurred. The greater the market impact of a trade, the lower the trading profits.

One result is that the prospect of a market impact can reduce the number of executed trades. In their 1992 study, Perold and Salomon explain: “As assets under management grow, more shares go unexecuted as the desired block size rises above the wealth-maximizing trade size. As more shares go unexecuted, opportunity costs increase, and the portfolio's rate of return declines as a percentage of assets.” The trades that remain unexecuted stymie the manager's ability to generate future excess returns. In addition, since an order from a large fund can have such a large market impact, investors with knowledge of the impending order can capture some of the profit the fund would otherwise have enjoyed by executing anticipatory trades, a practice called front-running. Front-running can even move prices away from a fund manager's preferred buy/sell range, resulting in unexecuted trades. In a nutshell, as a fund grows, it faces

increasingly unfavorable market conditions for the manager's trade orders.

Fund Size and Style Drift

A 1996 study by Ciccotello and Grant (“Equity Fund Size and Growth: Implications for Performance and Selection”) examined mutual fund returns from 1982 through 1992. The authors concluded that a subset of aggressive small funds performed significantly better than large funds. Managers of these aggressive funds are more likely to invest in small company stocks, and these investments may explain the funds' relative outperformance. The authors speculate, “finding these ‘diamonds in the rough’ may become more difficult as the fund grows.”

If a fund can't find enough new investment opportunities to soak up its cash, it must try to increase its existing positions. Funds that invest in large cap stocks can increase their positions without incurring much market impact. Small cap funds, on the other hand, invest in stocks that are inherently more thinly traded. Large transactions in small caps therefore have greater market impact costs than similar transactions in large caps. But an aggressive manager lacking small cap investment opportunities must put incoming cash somewhere, and by necessity must look to larger cap stocks as a way of soaking up unwanted cash in the portfolio. As a result, the fund gradually drifts away from its original strategy and finds it is unable to achieve its former level of returns.

International research also concludes that fund asset growth affects performance, but adduces different reasons. A 2005 study of Australian mutual funds (Chan, Faff, Gallagher & Looi, “Fund size, fund flow, transaction costs and performance: Size matters!”) finds that smaller funds focusing on small caps outperform larger funds, primarily because larger funds configure their portfolios to avoid anticipated transaction costs and portfolio frictions. This reconfiguration often results in a tilt away from owning smaller, less liquid stocks – which, because they are thinly traded, often have greater bid/ask spreads than more heavily traded shares – and leads to sub-optimal portfolio implementation. The authors conclude that, “... the decision to alter portfolio configuration

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in an attempt to reduce market impact costs is itself costly ...”

Impact of Manager Compensation

Another factor contributing to style drift is manager compensation. Since managers are typically paid as a function of the amount of assets under their management, they have an incentive to increase the size of their funds. As a successful small cap fund attracts more assets, the manager’s compensation increases; however, as previously discussed, his ability to achieve superior returns in small caps decreases. Rather than take riskier bets to boost returns — which, if the bets go sour, might trigger an asset outflow, and a pay cut — the manager may adopt a more conservative strategy. Such defensive strategies tend to push a fund’s return closer and closer to that of the market, so that the fund starts to resemble a passive index fund. Unfortunately for investors, compensation schedules designed to reward managers for actively seeking heroic returns do not change to reflect the new, closeted passive strategy. The fund’s expense ratio stays high, because it must still pay an “active” manager, even as its returns trend closer and closer to those of less costly passive funds.

Optimal Portfolio Size

Quantifying the optimal size for an actively managed portfolio is one of the more interesting results from research into the size/performance issue. Perold and Salomon suggest that the optimal portfolio size might be small, relative to the size of typical mutual funds. They write: “... with billions of dollars under management, a firm has to have very low market impact costs and/or a high alpha to create wealth. For what many would regard as a ‘good’ alpha — in the 1 to 3 per cent range — and ‘reasonable’ transaction costs — market depth in the 0.25 to 0.35 per cent range — the right amount of assets is only a few hundred million dollars.” Beyond this optimal point, continued flows into a fund cannot earn excess returns and only serve to dilute the interests of existing shareholders.

Other studies have looked at the marginal benefits and costs for each additional investment dollar. A 1999 study by Indro, Jiang, Hu, & Lee,

(“Mutual Fund Performance: Does Fund Size Matter?”) used regression analysis on a sample of 683 active funds over the 1993 through 1995 period. The study shows that funds below a minimum size have insufficient returns to justify the extra costs of active management. As funds increase in value above a breakeven point, active management sees increasing returns. Nevertheless, the proportional gains from active management become smaller and smaller as assets increase. The maximum net gain occurs in funds with assets between \$894 million and \$2.1 billion. The study shows that an optimal fund would have between \$946 million and \$1.1 billion of net assets. Of the 683 funds examined in the study, approximately 20 percent of funds failed to reach a threshold size where active management benefits were sufficient to overcome costs. Furthermore, approximately 10 percent of funds suffered negative marginal returns because they exceeded their optimal size. Langdon B. Wheeler CFA, Chief Investment Officer for Numeric Investors, writes in his 1998 study: “if active managers understood their transaction costs, they would realize the impact of size on returns and concede that they cannot forever increase their business and honestly expect to generate positive added value. Every strategy thus has a point beyond which the dollars of excess return will decline. No investment strategy should grow beyond that point.”

And Now For Something Completely Different ...

A 2004 working paper by Berk & Green (“Mutual Fund Flows and Performance in Rational Markets”) takes a drastically different approach to examining the size/performance issue. The authors begin with the observation:

“The relative performance of mutual fund managers appears to be largely unpredictable using past relative performance. Nevertheless, mutual fund investors chase performance. The evidence that performance does not persist is widely regarded as implying that superior performance is attributable to luck rather than differential ability across managers.”

Such defensive strategies tend to push a fund’s return closer and closer to that of the market, so that the fund starts to resemble a passive index fund . . . The fund’s expense ratio stays high, because it must still pay an “active” manager, even as its returns trend closer and closer to those of less costly passive funds.

“ . . . Every strategy thus has a point beyond which the dollars of excess return will decline. No investment strategy should grow beyond that point.”

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Rather than investigating empirical data, the authors sought to develop a model that would reproduce the “salient features of the empirical evidence as equilibrium outcomes.” The paper not only helps to understand the size/performance question, but also provides a powerful and elegant model of the underlying rationality of apparently irrational individual investor behavior.

Understanding the Model

The model echoes economic theories regarding the difficulty of maintaining excess profits over the long run in the face of competition. It incorporates three elements:

- Investors seek an efficient use of their money, so cash flows to the most successful fund managers.
- Fund managers face decreasing returns to scale, and exhibit differing ability levels.
- Investors experience a learning process, where key information is inferred from the time series of past fund returns.

A significant finding of the model is that “rational learning and strong response of [cash] flows to performance can be consistent with no persistence in performance ... these outcomes are not only consistent with investor rationality, but also with efficient provision of portfolio management services.”

The logic of the model unfolds as follows:

1. A history of success may be indicative of manager skill, or may be a random element attributable to mere chance (described in the study’s mathematical model as an “error term”).
2. Managers have an incentive to increase their compensation by increasing fund size. Managers recognize that superior performance will increase asset flows, but that generating superior performance is more difficult with larger funds.
3. Investors have an incentive to allocate investment resources to the most productive funds. Productive funds are identified by their superior performance.

Under the Berk/Green model, successful funds will continue to attract positive cash flows until the marginal dollar invested in the fund generates a benefit equal to the return of the market. This result, referred to as a “partial equilibrium” solution, implies that a manager will be unable to outperform the market in the future, but it does not prove that managers lack skill.

Despite its mathematical complexity, the model presents an elegant solution. It reconciles elements of the classic but simple efficient market hypothesis with more complicated models such as the Grossman/Stiglitz hypothesis of an “equilibrium degree of disequilibrium.” Moreover, the Berk/Green model justifies the behavior of mutual fund investors, and the cottage industries established to support their investment decisions. As the authors point out, their model does not provide support for the proposition that “... gathering information about performance is socially wasteful, or that chasing performance is pointless. It merely implies the provision of capital by investors to the mutual fund industry is competitive.”

The Berk/Green model presents another interesting conclusion. One of the greatest challenges faced by fund investors is identifying the portion of a fund’s excess return that is attributable to manager skill, and the portion attributable to random chance (the “error term”). However, if the error term is unique to the manager, investors may be able to diversify away much of the manager risk involved with holding an active portfolio. Instead of seeking the best investment manager in a particular asset class, investors choose to invest with a variety of successful managers. Such an approach is more likely to lead to future success than simply concentrating all assets in a single fund with the top performing track record. Another approach to diversifying manager risk is to invest in funds that use multiple sub-advisors.

In either case, the key for investors is to seek managers with uncorrelated error terms. Under this condition, “... by diversifying across funds with positive excess expected returns, investors can achieve the average excess expected return with certainty.”

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The model carries another implication: costs matter. Skilled managers need to find undervalued securities without adversely moving prices. The model assumes, however, that market costs are independent of manager ability. As skilled managers attract larger sums of money, they face increasing price impact and execution costs. As the probability that the fund will continue to earn excess returns tends towards zero, alpha will depend more and more on the fund's cost function. This is not all bad news for investors. Under competitive conditions, managers should adjust costs — such as manager compensation — in order to remain competitive. The authors write, “as in any equilibrium with perfect competition, the marginal return on the last dollar invested must be zero. In this case, however, since all investors in open-ended mutual funds earn the same return, *all* investors earn zero expected excess return in equilibrium ... the average excess return of all managers will be zero, regardless of their overall level of skill.”

Practical Application of the Academic Research

Academic research into the question of active manager skill tends to reinforce the general economic rule of diminishing marginal return: a manager is more likely to be successful in adding incremental value when the fund's size is relatively small. However, it can be difficult to determine precisely what fund size is optimal. Some studies conclude that optimal fund size is less than \$500 million. Others argue that funds are most efficient when they hold approximately \$1 billion under management, and continue to be relatively efficient provided that assets remain lower than about \$2 billion.

If investors use \$500 million as a cutoff, many popular actively managed funds are already too large to offer realistic possibilities of continuing excess returns. If \$2 billion is used, however, very few funds appear unattractive due solely to size. For example, according to data by Morningstar as of May 31, 2007, only 18 of the 244 funds listed in the US Small Blend stock category held assets greater than \$2 billion, and five of these funds were passively managed. Of potentially greater concern is the large number of funds that are so small that they may be uneconomical. Although

the studies were less clear regarding minimum asset size, Morningstar lists 81 funds with less than \$50 million in assets, and 31 funds with less than \$10 million.

As a practical matter, relying on a single metric, such as asset size, to evaluate the relative attractiveness of a fund is inherently flawed. Even if there is such a thing as an “optimal” asset size for a mutual fund, it will vary, based on market characteristics. Funds that invest in relatively illiquid markets, such as foreign small cap value stocks, will have a smaller optimal size than funds that invest in relatively liquid markets, such as US large cap growth stocks. Furthermore, obtaining information about a fund's asset size may not provide sufficient information about whether it is optimal.

Another problem confronting investors is that funds are often offered in multiple share classes. Asset size is measured and reported independently for each share class, but the manager's ability to add value is a function of the sum of assets in all share classes. For example, Neuberger Berman Genesis (Investor Class), a US Small Blend stock fund, holds just over \$2 billion in assets — about the top end of asset size for effective management, according to the Indro, Jiang, Hu, & Lee study. However, the fund is also offered in three additional share classes representing an additional \$9 billion of assets. A prospective investor evaluating this fund might reach different conclusions, depending on which share classes were reviewed.

Compounding this problem, successful managers often supervise significant pools of assets outside their mutual funds. This can take the form of sub-advising other mutual funds, or managing separate accounts for institutional investors. To the extent that such outside pools are invested in securities similar to those of the mutual fund under evaluation, its reported assets may understate the impact that management's trading decisions will have on markets. In this case, a fund that appears to be near the optimal size may in fact be part of a significantly larger than optimal asset pool.

An investor contemplating investing in an actively managed fund thus faces a difficult decision. A fund operated by an established manager with a consistently successful historical track record

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. . . a fund operated by an established manager with a consistently successful historical track record is more likely to have developed that record as a result of superior skill. Unfortunately, however, the established, successful manager is also likely to be managing significantly more assets than a newer manager.

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is more likely to have developed that record as a result of superior skill (luck comes and goes, but skill should persist). Unfortunately, however, the established, successful manager is also likely to be managing significantly more assets than a newer competitor. If the academics are right, the established manager responsible for a larger asset base will see his ability to deliver excess returns diminish over time. So which manager should the investor select? The answer is not clear.

SCLC suggests that investors who opt for active management should be aware of the impact of fund size on expected future excess returns, although size should be just one of the many factors considered when selecting funds. Investors should then seek to diversify, to the extent practical, their active manager risk. Active manager risk is, by definition, idiosyncratic, diversifiable, or unsystematic risk (risk that is unrelated to a comparative benchmark or asset class proxy). Trust law acknowledges that it is imprudent to ignore diversifiable risks. The “Principles of Prudence,” as described in the Restatement (Third) of Trusts, indicate that, “in the absence of contrary statute or trust provision, the requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks.” This suggests that prudent investment policy should consider arraying active managers in such a way that the idiosyncratic risk of one

manager is offset by those of the others. This is not an argument for “closet indexing,” which, according to the academic literature, appears to be wasteful, but rather a recognition that it is prudent to consider active manager risk in the context of the whole portfolio.

Additionally, SCLC observes that the preponderance of academic evidence concludes that it is difficult for active managers to achieve positive excess returns on an after-tax basis. Higher turnover active strategies generally trigger taxation sooner than comparable passive strategies, while passive strategies typically generate a higher portion of total return from capital gains, which receives favorable tax treatment. Research into the “asset location” question (see our *Investment Quarterly* from the 2nd quarter of 2006) confirms that the ideal location for employing an actively managed investment strategy is in a tax favored account, such as a 401(k), IRA, charitable trust, or foundation, where differential tax rates will not apply. The burden of proof regarding the prudence of active management for taxable portfolios is considerably higher.

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Jones Industrials gaining 23.0%. Many analysts predicted that large cap stocks, which have been market laggards for the past five years, would eventually outperform smaller companies. This rationale is partly based on historical data indicating that large companies with stable earnings perform well in the late stages of an economic expansion. As the current bull market enters its sixth year, early evidence suggests that this trend may be under way.

Foreign Stocks

Returns from developed foreign markets were mixed but nonetheless positive. The MSCI

Pacific Stock Index was up 2.2% for the quarter and 15.8% for the trailing twelve months. The MSCI Europe Stock Index jumped 8.3% in the past three months, pushing its 12-month total return to 32.4%. The run up in emerging market stocks was the big story for the quarter, following their plunge and recovery earlier in the year. The MSCI Emerging Market Index climbed 14.1% from April through June, pushing its twelve-month return to 41.8%.

US trade and budget deficits continued to depress the dollar during the quarter. Concurrently, economic strength in many foreign countries caused their central banks to raise interest rates,

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SURVEY OF INDICES & FUND AVERAGES
PERIOD AND ANNUALIZED COMPOUND RETURNS IN PERCENT

	Second Quarter 2007	12 Month Ending 06/30/07	3 Years Ending 06/30/07	5 Years Ending 06/30/07	10 Years Ending 06/30/07
Inflation Index & Risk Free Rate					
Consumer Price Index	1.09	2.52	3.11	2.92	2.62
U.S. 3-Month Treasury Bills	1.24	5.07	3.68	2.67	3.66
U.S. Stock Market (Large Companies)					
Standard & Poor's (S&P) 500 Index	6.28	20.59	11.68	10.71	7.13
S&P/Citigroup Large Cap Growth Index	6.63	19.37	7.61	8.38	5.08
S&P/Citigroup Large Cap Value Index	5.95	21.77	15.88	13.07	8.46
Average Large Cap Blend Fund ‡	6.21	19.50	11.70	10.29	6.96
U.S. Stock Market (Small Companies)					
Russell 2000 Index	4.42	16.44	13.45	13.88	9.06
Dimensional US Micro Cap Fund	4.35	15.98	13.09	15.89	13.15
Russell 2000 Growth Index	6.69	16.83	11.76	13.08	5.28
Russell 2000 Value Index	2.30	16.06	15.02	14.62	12.14
Average Small Cap Blend Fund ‡	5.51	17.02	14.19	13.86	10.83
Real Estate					
DJ Wilshire REIT Index	-9.47	11.64	22.29	19.26	13.93
Fixed Income (Bond) Markets					
Lehman Government Bond Index	-0.33	5.56	3.62	4.09	5.85
Average Intermediate Gov't Bond Fund ‡	-0.73	5.00	3.04	3.21	4.94
Lehman Municipal Bond Index	-0.67	4.70	4.56	4.61	5.44
Avg. California Intermed/Short Muni Bond ‡	-0.42	3.75	3.18	3.03	4.08
Credit Suisse High Yield Bond Index	0.62	12.14	9.05	11.84	6.86
Citigroup World Gov't Bond Index	-1.54	2.86	3.32	6.30	5.33
Average World Bond Fund ‡	-0.59	4.46	4.39	6.55	5.20
International Stocks					
MSCI EAFE Foreign Stock Index	6.40	27.00	22.24	17.73	7.66
Average Foreign Large Blend Stock Fund ‡	7.04	26.76	21.74	16.02	7.15
MSCI Europe Stock Index	8.31	32.44	24.53	18.72	10.30
MSCI Pacific Stock Index	2.22	15.84	17.38	15.59	3.17
MSCI Emerging Mkt Index (excl. dividends)	14.06	41.76	34.84	27.08	6.70
Average Emerging Markets Fund ‡	14.86	45.91	36.94	28.82	9.84

‡ Source: Morningstar Principia 06/30/2007

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making foreign currencies more attractive. These combined effects make overseas vacations for US citizens more costly, but effectively increase the return on foreign stocks for US investors.

Fixed Income & Real Estate

Analysts attribute falling US share prices in June to factors more traditionally linked to fixed income than to equity markets: inflationary pressures and credit concerns. The demand for goods and services has steadily increased worldwide, soaking up any remaining excess inventory and utilization capacity and placing upward pressure on prices. The domestic bond market reacted with a significant up-tick in interest rates, with the yield on the 10-year Treasury note climbing to 5.25% in mid-June, the highest rate in five years. The huge subprime mortgage market, in which institutions loan money at variable interest rates to borrowers with below average credit ratings, continued to collapse. As low teaser rates on such loans began to escalate, there was an increased threat of rolling foreclosures across the country, which could further depress the housing market and, by extension, the overall economy. Since consumer spending drives roughly two-thirds of all economic activity, any material contraction in aggregate purchasing power could trigger a recession.

Despite the downturn in Treasury prices and the difficulties in the subprime mortgage market, corporations were able to issue a record amount of debt last quarter, a total of \$277 billion in investment grade bonds. The market's appetite for below investment grade issues continued unabated, as investors were willing to purchase debt from firms with historically large amounts of leverage. The difference in yield between risk-free Treasuries and junk bonds remained relatively small, suggesting that investors see little risk in lower quality issues. Second quarter total return from junk bonds (+0.7%) surpassed that of mortgage-backed bonds or the overall bond market (both categories losing 0.5%). Meanwhile, REITS plunged 9.5% for the quarter, in response to higher interest rates and the debacle in the subprime mortgage market. Despite that downturn, the twelve-month return on the REIT index remains positive at 11.6%.

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QUALIFIED RETIREMENT PLANS
PRIVATE INVESTORS
TRUSTS, ENDOWMENTS & FOUNDATIONS

Individual Country Returns Second Quarter 2007

	US Dollar	Local Currency
North America		
United States	5.6%	5.6%
Canada	14.5	5.6
Latin America		
Argentina	7.8	7.3
Brazil	23.9	16.6
Chile	16.7	14.1
Mexico	10.4	8.2
Africa		
South Africa	2.5	-0.3
Europe		
Austria	4.5	3.0
Belgium	6.6	5.1
Denmark	6.9	5.2
Finland	13.3	11.7
France	8.2	6.6
Germany	13.4	11.8
Great Britain	6.1	3.8
Ireland	0.7	-0.7
Italy	1.3	-0.2
Netherlands	5.6	4.1
Norway	12.6	9.0
Portugal	18.2	16.5
Spain	2.7	1.2
Sweden	6.0	3.6
Switzerland	2.6	3.0
Asia		
Australia	10.7	5.4
Hong Kong	11.3	11.3
Indonesia	14.2	13.1
Japan	-1.0	3.5
New Zealand	11.1	2.8
Philippines	17.8	12.9
Singapore	10.3	11.1
South Korea	21.3	19.2
Taiwan	13.6	12.9
Thailand	18.7	17.0

Source: Dow Jones Global Indexes