JULY 2011

GLOBAL MARKETS OUTLOOK

MFS INVESTMENT MANAGEMENT®

Equity Outlook

by Jeffrey D. Morrison, CFA

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EXECUTIVE SUMMARY

A slowdown in global economic momentum weighed heavily on global equities in the second quarter. Unrest in the Middle East; the earthquake, tsunami, and nuclear crisis in Japan; and renewed sovereign debt concerns in Europe, all contributed to steady stock declines during the period. Against this backdrop Jeffrey Morrison, in his Equity Outlook, discusses whether these events represent a soft patch or the start of an enduring trend. He expects global equity markets to rally in the short term given bearish investor sentiment. In his Fixed-Income Outlook, Robert Hall takes a look at how increased risk aversion has affected bond markets. US Treasury yields fell through most of the second quarter amid lower US growth. Meanwhile, Greek turmoil, he said, has led to a widening in the spread of peripheral European debt. With the expectation that economic growth will stabilize in the latter half of the year, Hall says that MFS continues to believe that expansion will lend support to riskier assets, including emerging market debt.

Q2 review — the perfect storm

A considerable slowdown in global economic momentum weighed heavily on global equities in the second quarter. Unrest in the Middle East carried over into the quarter, driving energy prices up more than 35% from the lowest level of the first quarter; higher energy prices negatively affected consumption in most developed economies. Additionally, the Japanese earthquake and tsunami and subsequent electrical power crisis resulting from the Fukushima nuclear disaster caused significant supply chain disruptions, particularly in the automotive and electronics industries. April and May brought tornados and floods to the US Midwest, which negatively impacted economic activity and disrupted transportation routes on the Mississippi River.

Adding to the perfect storm of the second quarter were renewed sovereign debt concerns in Europe. Throughout the period concerns over a debt default in Greece and the possible outcomes of contagion intensified. It is believed that a default by Greece would have a significant, but manageable, impact on French banks and the European Central Bank (ECB), but that a contagion to Portugal, Ireland, and particularly Spain would likely put the entire European banking system at risk. As the quarter wound down, a Greek debt default appeared to have been averted — after the Greek parliament passed the required austerity measures — a necessary precondition for a European bailout.

The MSCI ACWI (local) Index continued the rally that began at the end of the first quarter, reaching a level just below the February 18 high (a lower cyclical high) by the end of April, before retreating in a steady decline for the remainder of the quarter. On a geographic basis, markets in Asia produced the strongest results, reflecting a rapidly improving outlook in Japan, limited impact from the European sovereign debt debacle, and an outlook for lower inflation and a soft economic landing in China. US, UK, and core eurozone equity markets also demonstrated resilience in the face of macro headwinds, with German equities in particular posting the best results among developed markets. As the debt crisis intensified in the final month of the quarter and economic data weakened further, developed market leadership narrowed while emerging equity market leadership emerged.

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EQUITY OUTLOOK

JEFFREY D. MORRISON, CFA

INSTITUTIONAL PORTFOLIO MANAGER

Jeffrey D. Morrison, CFA, is an investment officer and institutional portfolio manager. He participates in the research process and strategy discussions and communicates investment policy, strategy, and tactics.

He joined MFS in 2006 and has 22 years of experience in the industry as an equity portfolio manager, capital markets analyst, and trader.

Jeff earned a Bachelor of Business Management (BBM) degree from Ryerson Polytechnical Institute. He holds the Chartered Financial Analyst designation.

Peripheral European markets, reacting to the precarious Greek debt situation, were among the weakest performers during the quarter. European equity markets outside the eurozone and markets in emerging Europe and Latin America were also negatively impacted by the slowing global economy and unpredictable situation in Greece.

Defensive sector leadership prevailed throughout the quarter, with the health care, consumer staples, utilities, and telecom sectors outperforming in both emerging and developed markets. The more cyclical consumer discretionary sector was a leader across all geographies. As would be expected with the deceleration in global economic momentum and the mid-quarter selloff of crude, the energy, information technology, and materials sectors broadly underperformed during the quarter.

Economic outlook – a pause that refreshes?

The drop-off in economic momentum in the second quarter has investors contemplating whether this is another so-called "soft patch" or the start of a more enduring economic slowdown or recession. While business surveys such as the JPMorgan Global PMI indices, which attempt to provide a gauge of current economic conditions, have weakened considerably in recent months, they continue to signal that the global economy continues to expand, albeit at a more moderate pace. The most recent OECD Composite Leading Indicator, designed to predict turning points in the economy's growth cycle, has clearly peaked and is rolling over; however, it remains well above the level that would signal a more serious downturn.

In our April report we referenced the Duke University/CFO Magazine survey which provides insight into the expectations of more than 800 chief financial officers around the world. The most recent survey, conducted in early June, confirms the deterioration of other indicators, with diminished optimism in all regions; the outlook of CFOs in China and the United States was particularly weak. One bright spot in the survey is that, despite the fading optimism, CFOs have not revised down their spending plans.

We expect the global economy will regain some momentum in the second half of the year but that the level of economic growth, particularly in most developed economies, will remain lackluster and choppy. The recent spate of soft economic data are largely attributable to transient issues such as the supply-chain disruptions caused by the earthquake and tsunami in Japan, soaring fuel prices resulting from unrest the Middle East, and severe weather in the southern and midwestern regions of the United States that impacted commerce and disrupted barge traffic on the Mississippi. A supply response, followed by a coordinated effort by the International Energy Agency to place an additional 60 million barrels of oil on the market, coincided with a significant pullback in the price of oil, which fed through to lower gasoline prices, particularly benefiting developed economy consumers. Japan, which represents only 7.5% of worldwide gross domestic product (GDP) but plays an important role in the auto and semiconductor supply chains, is quickly restoring production, which should provide a welcome boost to global activity in the second half. Reconstruction efforts in communities hit by tornados and floods in both Japan and the United States should accelerate in the second half, providing an additional boost to growth.

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United States

June brings an end to the US Federal Reserve Board's QE2 program, and the Fed has signaled that barring a sustained pickup in core inflation, it will remain on the sidelines — which limits the likelihood of a QE3 occurring. Fiscal policy continues to garner headlines, with the debt ceiling debate front and center. While fiscal policy at the federal level was set to be a headwind with the expiration of payroll tax cuts in 2012, rumors are swirling that the tax cuts will be extended and potentially be broadened to include employer contributions. A tax holiday for repatriated foreign earnings is also rumored to be under consideration. At the state level we expect further cost cutting and layoffs.

Despite broad weakness in regional Fed surveys, June's Institute for Supply Management's Manufacturing Index showed an unexpected increase. Even if much of the improvement is the result of a rise in inventories, the report added to other signs that the current soft patch may be temporary. First, the Business Roundtable CEO Capex Outlook Survey points to a second-half pickup in capital expenditures that should provide a welcome boost to recently weak employment trends. The surprising strength in May new orders for manufactured goods supports the likelihood of increased business spending. Another more constructive data point was the Senior Loan Officers' Survey, which indicated that banks are more willing to lend. Despite these more positive developments, large and small businesses continue to list uncertainties about taxation, regulations, health care costs, and budget deficits as barriers to increased confidence and investment. Finally, despite renewed weakness in housing and employment, consumer spending remains resilient. A recent US Federal Reserve Board Flow of Funds report shows household wealth increased $900 million over the past quarter. which helps explain the continued strength.

Europe and the United Kingdom

The recent passage of additional austerity measures by the Greek parliament virtually ensures Greece will receive the next €12 billion tranche of joint International Monetary Fund/European Union bailout funds July 8 and prevents a debt default and looming contagion to other peripheral countries and exposed banks. While this is not a long-term solution and does not completely remove the risk of default, it hopefully buys time for policymakers to negotiate a longer-term financing package. It is expected that Greece, along with Ireland and Portugal, will eventually need its debt restructured.

The economic profile of Europe can best be described as uneven, and with business surveys broadly declining in recent months, the divergences are likely to become exacerbated. Overall economic conditions within the eurozone are exhibiting trends comparable with those of the United States, inflation trends are similar, unemployment is gradually declining, and credit conditions have begun to show signs of improvement. Germany, whose unemployment rate has declined to the lowest levels since unification, continues to be the standout, with strength both in exports and final domestic demand. In contrast, peripheral countries, which are burdened by debt and austerity, are faced with moribund economic prospects.

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Growth in European countries outside the eurozone is also showing signs of deceleration, with strong exports offset by slower investment and consumption. The United Kingdom is facing stagflationary-type conditions, with the second-slowest recovery in the G7 and the highest rate of inflation in the developed world.

European central banks, which unlike the US Fed have the single mandate of monitoring inflation, are in broadly tightening mode. Despite an inflation rate two times greater than its official target, the Bank of England is keeping rates on hold, citing growth concerns and blaming the elevated CPI on transitory issues. Given the combination of fiscal restraint and monetary tightening, the economic outlook for Europe remains lackluster.

Japan

The Japanese economy continues to recover from the devastating March earthquake, tsunami, and subsequent nuclear crisis. Recently reported data points on industrial output confirm the monthly increase in the May Japan Markit PMI Manufacturing survey. Ayako Mikami, MFS' Asia auto analyst, provided further evidence of recovery, indicating that "in May, Japanese OEMs were producing at a 50% to 60% utilization rate" and that "the official plan at Toyota was to get back to normal by October to December." Also, earlier in June the Bank of Japan upgraded its economic assessment for the first time in four months and indicated that it expected GDP growth to turn positive in the fourth quarter, negating the need for further monetary easing. While electricity shortages may continue to hamper manufacturers' production schedules, we expect economic growth to accelerate in the second half as supply chains are restored and reconstruction demands pick up.

The consumer segment of the economy is also showing signs of recovery. May retail sales increased for the second month in a row, confirming the recent improvement in the Japan All Household Consumer Confidence Diffusion Index. Proposed tax hikes to fund reconstruction, if passed into law, will have a negative impact on future consumer spending.

Emerging markets

Both economic growth and inflationary pressures remain resilient in major emerging economies; however, restrictive fiscal and monetary policies are beginning to have an impact. PMI indices, which are designed to measure current economic conditions, continue to decelerate, evidenced by the recently released preliminary HSBC China Manufacturing PMI for May, which dropped to its lowest level in 11 months. Additionally, OECD leading economic indicators for the BRIC countries point to further weakness, with the Brazil and India readings already below the key 100 level — indicating slowdown.

While we expect inflation in emerging economies to peak and decelerate in the second half of the year, we do not expect policymakers to start easing policies anytime soon. Absent a severe economic downturn or more restrictive monetary policy by the US Federal Reserve Board, emerging economy policymakers will be forced to remain vigilant while tolerating inflation rates at the higher end of target ranges.

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Equity outlook and strategy

In the short term, global equity markets look poised to rally because key technical support levels have held so far and investor sentiment has reached extremely bearish levels (contrarily bullish). Additionally, it appears the passage of the Greek austerity package has raised investor optimism that one of the key risks to the market has been eliminated — at least for the time being. While we think a sizable summer rally is possible, we think we are at a point in the bull market where market returns are more muted and large-cap, growth, and quality leadership ebbs and flows between late cycle and early contraction markets and sectors, size, and style.

With global economic momentum slowing, earnings estimate revision trends below one,[1] and attractive relative valuations, our outlook on a geographic basis is to favor developed over emerging markets, with an emphasis on the United States and Japan. From a secular perspective, emerging markets continue to look attractive; however, from a cyclical perspective, slowing economic and earnings momentum, coupled with more restrictive monetary policies and unattractive relative valuations, leave us cautious. The United States and Japan, which are likely to regain economic momentum in the second half, have more attractive cyclical growth profiles with mixed earnings estimate revision trends and are reasonably attractive from a valuation perspective.

On a sector basis, a sluggish global economic outlook, combined with business cycle analysis and earnings estimate revision trends, suggest market leadership is likely to shift back and forth between late-cycle sectors (energy, industrials, select technology) and late-cycle defensive sectors (health care, consumer staples, utilities, and telecom). Reviewing the most recent earnings estimate revision ratios for global sectors indicates that technology (software and services), health care, telecom, and consumer staples have the strongest trends, while materials, technology (hardware), autos, media, and industrials have the weakest trends. While there are some minor regional divergences, earnings and relative performance trends have turned broadly defensive. Notable divergences include positive trends for industrials and energy, coupled with weaker trends for telecom in the United States and Europe and positive trends in retailing and real estate in Asia ex-Japan.

On a style, quality, and size basis, the economic outlook and estimate revision trends clearly support growth, high-quality, and large-cap leadership.

Some final thoughts: A similar leadership transition last year was ultimately reversed when the global economy reaccelerated. While a similar reversion could occur again, we doubt that the anticipated reacceleration will be as robust as the one that occurred last fall.

While we were previously positive on developed companies with emerging market exposure, current valuations and slowing economic momentum in emerging economies has us cyclically more cautious on that subgroup.

[1] Estimate revision trend – (# of FY1 and FY2 upward EPS revisions over the past three months - # of FY1 and FY2 downward EPS revisions over the past three months)/ total FY1 and FY2 estimates over past three months

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EQUITY OUTLOOK

MSCI indices (gross)

Name	1 month	3 months	YTD	1 year
EMU	-0.84%	0.98%	4.87%	17.44%
EUROPE ex-EMU	-2.23%	0.32%	1.21%	18.36%
USA	-1.70%	0.21%	6.18%	31.47%
EAFE	-1.19%	-0.53%	0.53%	13.82%
ACWI	-1.59%	-0.73%	2.54%	21.71%
EM ASIA	-2.33%	-1.06%	-0.38%	17.99%
Japan	0.87%	-2.38%	-5.09%	3.29%
EM	-1.85%	-2.58%	-1.89%	17.13%
PACIFIC	-0.31%	-2.58%	-3.51%	6.99%
Pacific ex-Japan	-2.09%	-2.85%	-0.92%	13.96%
EM EMEA	-1.29%	-3.11%	-0.14%	23.12%
BRIC	-1.74%	-4.81%	-3.23%	11.64%
EM Latin America	-1.05%	-5.73%	-6.70%	11.08%

Source: Bloomberg. Returns in local currency, as of 6/30/11.

MSCI AC world sectors (price)

Name	1 month	3 months	YTD	1 year
Health care	-1.84%	5.82%	8.64%	17.47%
Consumer staples	-2.02%	3.94%	3.24%	15.84%
Consumer discretionary	0.06%	3.31%	4.05%	28.85%
Utilities	-0.09%	-0.90%	-1.90%	4.48%
ACWI	-1.80%	-1.69%	0.97%	18.60%
Telecom	-1.28%	-1.82%	1.34%	15.73%
Industrials	-1.13%	-2.38%	1.97%	23.97%
Information technology	-3.12%	-2.65%	-1.42%	17.88%
Materials	-1.33%	-3.50%	-3.19%	24.32%
Financials	-2.42%	-4.74%	-2.93%	8.44%
Energy	-2.50%	-6.65%	4.00%	32.32%

Source: Bloomberg. Returns in local currency, as of 6/30/11.

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MFS INVESTMENT MANAGEMENT

Fixed-Income Outlook

by Robert M. Hall

ROBERT M. HALL

INSTITUTIONAL FIXED-INCOME PORTFOLIO MANAGER

Robert M. Hall is an investment officer and institutional fixed-income portfolio manager. Rob communicates investment policy, strategy, and positioning to institutional and retail clients around the world.

Rob joined MFS in 1994 as a marketing associate for MFS Institutional Advisors, Inc., and later became responsible for client service for the firm's non-US separate account clients. He formerly served as a vice president of marketing at MFS International Ltd., a subsidiary of MFS. During his tenure he served as the division's senior product manager, providing information about portfolio positioning and strategy and serving as a liaison with portfolio management.

Rob graduated from Gordon College with a bachelor's degree. He earned a master's degree in education from the University of Massachusetts, Lowell.

Duration/Rates

The recent weakening in global economic activity has prompted downward revisions to consensus growth forecasts. This moderation is reminiscent of a similar trend in evidence at the same time last year, and, like last year, our baseline expectation is that this will prove to be a temporary "soft patch." Peripheral eurozone sovereign risk has also once again captured the market's attention, as Greece has struggled to implement additional adjustment measures and European policymakers have debated private creditor participation in "bailout" programs. The turmoil has led to spread widening in other peripheral countries' interest rates, but our core expectation is that policymakers will be able to implement measures to ring-fence Greece and contain contagion risk at least for a period of time. The "tail" risks of less favorable outcomes cannot be dismissed, however.

US Treasury yields fell over most of the second quarter in response to heightened risk aversion and lower growth forecasts. We think the near-term risk to rates is now roughly symmetric, *i.e.*, approximately equal probability of rates reversing direction or falling further. While some US data series appear to be bottoming, it may take some time for evidence of firming activity to lead to a significant improvement in risk appetite.

Nevertheless, with the expectation that the pace of US economic growth will recover to a moderate level in the second half of 2011, we have maintained a negative bias toward rates. A rebound to 2.5% to 3.0% annualized GDP growth, along with inflation that may push past the upper end of the US Federal Reserve Board's comfort zone, suggests to us that US Treasury rates may be too low, even for an economic environment where the healing process may require years. We are not looking for a backup in rates of "bond bubble" proportions anytime soon. With the expectation of slow progress back toward full employment and "normal" macro conditions, we think that real rates are likely to stay comparatively low versus historical levels for an extended period. Treasury rates appear likely to remain relatively range bound, but we feel they are probably closer to the bottom of the range than the top and the risk to rates over the balance of the year is therefore skewed toward higher levels.

In our view, the Fed will keep rates on hold for some time after QE2 ends. We see little immediate scope for a QE3, and we feel that a hike in the federal funds rate will probably be deferred until 2012. With the fed funds rate anchoring the front end of the curve, the curve should remain relatively steep. If our scenario of a second-half rebound plays out, however, there is a risk of a bear flattening of the yield curve as macro improvement persuades the market that monetary policy could be approaching an inflection point. In this event, the belly of the curve (2s to 10s) will likely feel the most pain.

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FIXED-INCOME OUTLOOK

Treasury Inflation-Protected Securities

Breakeven inflation rates fell sharply through much of the second quarter as the softening trend in US macro data raised expectations that inflationary pressures could ease along with economic activity. Based on the view that the economy will likely strengthen in the second half of the year, we think breakevens have become too cheap. In our view, breakevens could widen to levels more consistent with moderate growth, driving outperformance of TIPS versus nominal US Treasuries, once the data flow improves. As a result, we think TIPS look modestly attractive versus nominal US Treasuries and other "AAA"-rated debt.

Agencies

Agency spreads remain tight to US Treasuries and consequently offer little value.

Mortgage-backed securities

In our view, the spread offered by agency mortgage-backed securities makes them modestly attractive versus US Treasuries, especially in the event of a backup in Treasury yields, though our bias is to favor corporate credit over other spread product. As a result, we have remained neutral to underweight MBS in our diversified US fixed-income portfolios. Technicals remain a source of volatility for the sector. On a positive note, repayment risk remains low because of tight refinancing standards.

Investment-grade corporates

We continue to find high-grade corporate bonds relatively attractive. Fundamentals and technicals for investment-grade corporates have, in our view, remained solid. Valuation has shown modest improvement as spreads have widened on macro worries and peripheral eurozone sovereign risk. As a result, high-grade corporate spreads are starting the second half of 2011 at close to where they started the year, suggesting to us that there is some potential for tightening as risk factors subside. We continue to find good value in financials, where recent widening has been particularly notable, as well as in "5B" or crossover credits, especially in the context of year-to-date wides in the spread between "BB" and "BBB"-rated credits. We think event risk could rise, however, due to conditions that seem particularly favorable for M&A/LBO activity. As a result, we think selectivity remains critically important to managing an allocation to corporate bonds.

High-yield corporates

Earlier this year we became concerned about tight valuations in the high-yield corporate bond sector and accordingly adopted more defensive positioning in our dedicated high-yield portfolios. We recognized that reducing portfolio risk even as high-yield momentum remains intact could potentially mean sacrificing some near-term upside performance but could ultimately be the more prudent strategy because it provides a measure of defense against downside risk.

Yield in the asset class fell to historic lows in mid-May, just as several macro risk factors merged in "perfect storm" fashion. Our defensive positioning proved beneficial in the ensuing selloff, which we view as a healthy correction that has left valuations in the asset class at levels we consider fair value or better.

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With the macro view that global expansion will continue at a modest pace, we think risk appetite will recover and that underlying high-yield corporate fundamentals will remain solid. We have accordingly begun incrementally adding risk back into our portfolios. Even when valuations in the asset class looked stretched, we felt that high yield offered a reasonably attractive spread cushion to protect against the risk of an eventual backup in Treasury yields. At current wider levels, we feel it offers an even better value proposition as a defense against higher rates.

Emerging market debt

With the expectation that economic growth will stabilize in the latter half of the year, we continue to believe that expansion will lend support to riskier assets, including emerging market debt. We remain constructive on both dollar-denominated and local-currency emerging market debt, though we recognize that volatility could stay elevated in the near term as the market looks for confirmation of the expansion's resilience. Positive trends in emerging market credit fundamentals remain largely intact. There are a few sovereigns where idiosyncratic or country-specific risk has fluctuated in recent months. On balance, however, the most significant risks to the asset class appear to be external factors such as the risks of a resurgence in oil prices or a major deterioration in the debt sustainability of peripheral eurozone sovereigns.

Within dollar sovereigns, we continue to find the best relative value in the higher yielders, which should benefit from a more supportive global backdrop in the second half of the year. We think local-currency emerging market debt offers good long-term opportunity, but we recognize near-term challenges as well. While local currency debt may offer somewhat higher total return potential than hard currency debt, we think it will likely remain higher beta to risk events and consequently more volatile. As a result, we believe that the risk-adjusted return potential for local currency and hard currency debt could remain very similar.

Municipal bonds

Technical factors have remained a major driver of municipal bond performance. While there have recently been some signs of a modest pickup in supply, new issuance has been very light year to date, with a run rate of only about half of last year's level. Although we are just starting to witness a shift toward positive net flows in municipal bond funds, demand for muni paper should remain well supported by substantial cash flow driven by near-record amounts of municipal debt maturing or being called in July.

The muni bond rally has continued even as global macro risk factors have buffeted the credit markets, but yields have yet to return to the low levels prevalent before the November to January selloff. Despite their outperformance, we continue to see good value in munis versus other fixed-income assets. In our view, the income differential for investors able to fully utilize the tax benefits of munis is substantial. On a tax-equivalent yield basis, many investment-grade muni bonds have been outyielding low-quality taxable bonds by wide margins. With this yield advantage in mind, we continue to believe that the patient investor with a longer-term horizon is likely to be fairly compensated for holding municipal bond risk.

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FIXED-INCOME OUTLOOK

Negative news flow related to municipal finance has recently subsided as the market's attention has been focused on a range of other issues, including the US debt ceiling, a broad-based slowdown in global macro data, and sovereign risk in peripheral Europe. Nevertheless, we think that the potential for volatility in the asset class will likely remain elevated.

We continue to see relatively attractive opportunities in essential service revenue bonds of issuers in the lower end of the investment-grade spectrum.

Fixed-income indices

Name	1 month	3 months	YTD	1 year
BarCap US Govt Treasury Index	-0.34%	2.39%	2.22%	2.24%
BarCap US TIPS Index	0.81%	3.66%	5.81%	7.74%
BarCap US MBS Index	0.09%	2.28%	2.87%	3.77%
BarCap US Corp Bond Index	-0.88%	2.28%	3.16%	6.29%
BarCap US HY Corp Bond Index	-0.97%	1.05%	4.97%	15.63%
JPMorgan Global Govt Bond Index	0.19%	3.33%	3.89%	10.15%
JPMorgan EMBI Global	1.12%	4.03%	5.09%	11.73%
JPMorgan GBI EM Global Diversified	0.46%	3.95%	6.93%	19.67%
BarCap Muni Bond Index	0.35%	3.89%	4.42%	3.48%
BarCap Muni HY Bond Index	1.87%	5.29%	4.98%	5.47%
BarCap US Agg Bond Index	-0.29%	2.29%	2.72%	3.90%

Source: SPAR, FactSet Research Systems Inc., as of 6/30/11.

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