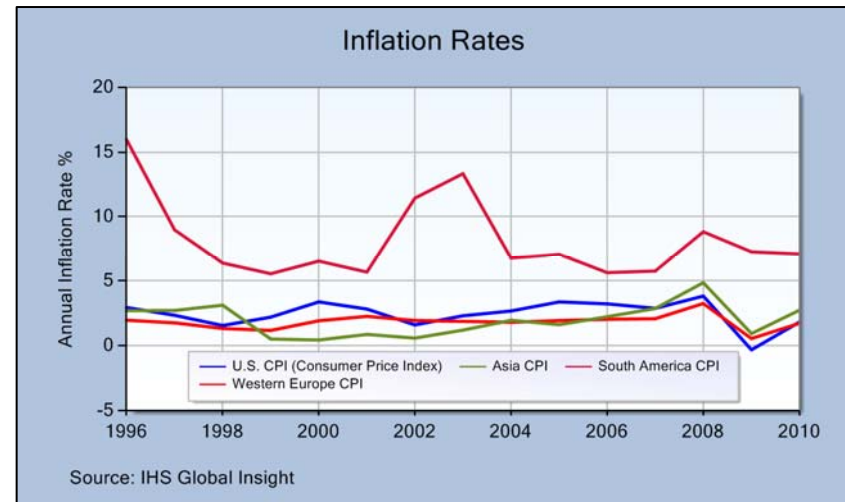


Economy and Market Review

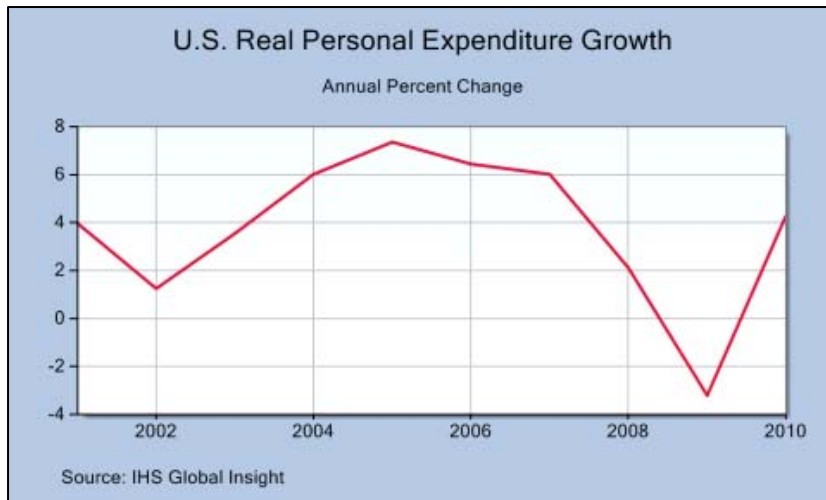
(All returns in dollars and include net income unless stated otherwise.)

Investment climates can change rapidly in three months. The 2nd quarter of 2010 began with general investor perception of an improving U.S. and global macroeconomic environment. Corporate managers generally espoused confident earnings outlooks, equity market volatility was making new lows and most economic reports reflected synchronized recovery across the globe. Indeed, greater concern was focused toward the improving economy heating up inflationary concerns with several central banks, including Australia, India and China, hiking interest rates. This, in effect, took away the punch bowl by draining liquidity from financial markets. The U.S. 10-year treasury yield was pushing towards 4%, up 80 basis points in six months, and many analysts were projecting 5% by year end. Fast forward to the end of the quarter and confidence had turned to fear. Equity volatility doubled, 10-year treasuries yields plummeted to less than 3% and global economic fears escalated. From the recent peak on April 15, global equities are off -15.65% as measured by MSCI All Country World Index. For the quarter, U.S. large cap and small-mid indexes lost -11.43% and -9.98%, respectively, as measured by the S&P 500 and Russell 2500. Foreign equities suffered a more severe drop, losing -14.45% as measured by iShares MSCI All Country World Index ex USA Fund. It appears that the four impacts of China’s tightening, Europe’s Greek crisis, Washington’s financial regulation uncertainty and the Gulf oil debacle were too much for equity markets to handle. Although the enthusiasm going into the quarter was clearly inappropriate, we believe the excessive pessimism exiting the quarter may be as well.



Investors now fear the “double-dip,” or the return to a recessionary economic climate in the U.S. and global economy due to impacts from the European sovereign debt crisis and China’s efforts to cool real estate price appreciation. Although possible, double-dip recessions are rare, occurring in less than 10% of the registered recessions since 1854. The last recorded instance was 1981. Moreover, we believe double-dip fears

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are overblown. First, the Greek crisis, while not insignificant, is much smaller than the subprime mortgage crisis. With a potential bad debt problem of less than \$400 billion, this amounts to a little more than one year of Western Europe financial sector earnings. Better public finances in the core of Europe, especially Germany, provide the means for supporting Greece and the euro while Greece takes the necessary steps to set up responsible fiscal policy. Second, the global economy is generally stronger than it was at the end of 2008, with impressive momentum in many emerging markets. The U.S. economy looks to be on pace for a 3% plus rate of growth in 2010. Asia and Brazil should exceed 6%. Finally, China appears well equipped to deflate the real estate bubble through the use of administrative controls and increased housing supply. Indeed, we believe a “soft landing” in China is the more likely scenario. China’s balance sheet metrics are much better compared to most countries with debt with a GDP of less than 20%, versus over 90% for the U.S. Thus, at the first sign of trouble, we believe China will provide additional stimulus to the economy, as they have the means to do so.

Stripping away the noise can be difficult in this age of always-on media, but the main determinant of equity prices are the direction of corporate earnings. *Pari passu*: with increasing earnings, stock prices rise. Earnings are driven by economic growth, which in turn is influenced by a host of factors, including, most importantly, consumer income growth, availability of credit and the steepness of the yield curve (the yield advantage of longer maturity over shorter term debt). Central bank policy influences credit availability and in most environments takes direction from inflation.

Other data confirm the idea that consumers are past the worst. Mortgage delinquencies have peaked, consumer interest payments from mortgages and other debt are making new lows as a percent of disposable income and banks have started to ease lending standards. In summary, conditions are getting better for consumers. The corporate outlook is even better in our opinion. Free cash flow is at an all-time high and cash on hand is at a 50-year peak in the U.S.

Foreign economies also reflect strength. Japan registered nearly 5% growth in the first quarter 2010. The export-driven economy continues to be driven by China, India and other Asian economies hungry for Japan’s advanced machinery and electronics while domestic consumption also improved due to various “green” stimulus programs. We believe the strong yen will cap economic performance going forward, but years of deflation have taught companies how to remain competitive through extensive cost cutting techniques. In spite of painful austerity programs



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planned for Italy, Spain and other countries in Western Europe, survey data shows increasing business confidence as the weaker euro improves European competitiveness in the global market place. Indeed, European industrial production and exports reflect a continuing recovery. Again, this suggests the equity market assumes more dramatic economic weakness than is currently occurring.

This cycle is also following the familiar investor pattern. After an extensive correction, investors initially invest money into fixed income. Monthly net inflows into bond mutual funds remain brisk, as investors, with painful memories of equity losses in 2008 (and the most recent quarter), move to safer, higher-quality fixed income and cash. This tends to push up bond prices and indeed, by our metrics, most corporate bonds are expensive relative to equities – a condition probably accentuated by hedge fund techniques of buying corporate bonds or credit default swaps and selling the company's common equity short to "hedge" their position. Corporations, however, recognize the opportunity afforded by very low interest rates. Several companies currently pay less in debt interest than the dividend yield on their stock. Interest, of course, has the additional benefit of being tax deductible, enticing companies to issue debt to retire their stock. We look for significant net equity retirement to begin soon.

Portfolio Review*

Our dividend-oriented and small-mid core strategies posted negative returns in the quarter but defended better than the comparative indexes in the three-month period. For U.S. Dividend we added two new positions: Omnicom (OMC) and American Express (AXP). Omnicom is a global leader in advertising, marketing support and public relations. We believe OMC can outperform throughout the upcoming economic cycle as (1) the company offers above-average earnings growth but trades at a modest discount to its peer group, (2) emerging market exposure should benefit organic growth trends, and (3) return of capital to shareholders is among the highest in media. Recent management commentary noted strength in almost all business units, except auto and parts of Europe, implying a broad-based recovery. The company bumped up the dividend by 33% in February. We are bullish on AXP's growth prospects due to its focus on charge cards and its premier rewards platform. A key investor debate surrounds the firm's expense ratio, but we view AXP's expenditures as a way to drive future growth and capitalize on attractive opportunities not available to some peers as they exit the credit downturn. We expect AXP to maintain its market leadership in rewards and to expand into additional markets and customer sets. Net charge-offs are declining and prospective, potentially-harmful interchange legislation is unlikely in our view.

New purchases for International Dividend included Singapore Press Holdings (SGPRY), Danieli (DNIYY) and iShares Malaysia (EWM). Positions sold during the quarter either had limited growth potential (Wolters Kluwer), guided toward a lower cash dividend (EFG International), reached near-term price appreciation (Amada) or were part of a portfolio risk repositioning (BBVA). SGPRY is a newspaper, media and property company based in Singapore. SGPRY should benefit from Singapore's advertising market rebound and remains committed to paying out a "high percentage of recurring earnings" to shareholders. Hence the 6% plus dividend yield should be supported by the stable core print business and solid property portfolio. DNIYY is an Italian steel-making equipment maker and also has a small steel making division. We purchased the savings shares which have preferential treatment in receiving company dividends. The savings shares also trade at a 45% discount to the ordinary shares. DNIYY steel-making equipment uses electric arc technology instead of the conventional blast furnace technology. Further, DNIYY is unique in that their equipment can process iron ore. The electric arc technology previously had only been able to create steel from steel scrap. DNIYY is currently the only company in the world that can produce this technology and has a 5-year headstart on the rest of the industry. With DNIYY's equipment, steel producers can respond to market conditions in a quicker fashion. Blast furnace plants take months to shut down and months to start back up making the business cycle that much more extreme. With electric arc, steel producers can modulate production on a daily basis. The plants are

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also less expensive to build and more economical for lower levels of production. African and Middle East producers like the technology for both mini mills and more extensive jumbo plants to provide for their infrastructure needs. The company has been receiving new orders from many emerging markets including Saudi Arabia, the United Arab Emirates, Vietnam and many countries in Africa. The company has conservative accounting and trades at a low single-digit multiple to cash flow. We invested in Malaysia due to the country's positive trade and fiscal surpluses and anticipated currency strength. Due to Malaysian capital controls, new ADR creation or de-conversion is not possible. Given the illiquid nature of the existing ADRs, we believe the iShare is the best alternative. The iShare currently trades at a low single-digit earnings multiple but has an attractive dividend yield. Political risk is always prevalent in Malaysia but election turmoil has subsided and IHS Global Insight shows an improving 12-month trend in the country's overall risk score. The tax system and infrastructure is conducive to business. Government operations, while inefficient, do not rank high in corruption compared to other emerging markets. Crime levels are relatively low and terrorist activity has been more prevalent in Indonesia compared to Malaysia. Malaysia's first quarter 2010 GDP at 10.1% ranked near the top in the region as well as the world.

Global Dividend trades included the sale of Amada, EFG International, BBVA and Wolters Kluwer. Buys included iShares Malaysia (EWM) and Danieli (DNIYY) mentioned above, as well as Microsoft (MSFT). MSFT's positive earnings growth is being driven by the new desktop product cycle including Windows 7 and Office 2014. Increased corporate capital expenditures to upgrade old computers are unleashing significant pent-up demand for an improved operating system from Vista and XP. The stock's earnings multiple is at a discount to projected earnings growth and we expect a significant cash dividend hike to be declared in September.

For Small-Mid Core we took a defensive stance as the market weakened during the three months, selling four names and buying just one: Weyco Group (WEYS). Sales included Symx Technologies (SMMX), Fidelity National Information Services (FIS), Psychedics (PMD) and T. Rowe Price International (TROW). SMMX was a disappointment for us as it struggled to shift its business strategy from a high-throughput materials discovery firm to a software-dominated firm focusing on electronic notebook/enterprise-wide lab data sharing. A takeover bid lifted the share price to a near-term high and an attractive point to exit the position. FIS also moved to a multi-year high on news of a possible buyout by Blackstone. We received the FIS shares originally when Fidelity National Financial (FNF) split into multiple companies. In our judgment, FIS had limited additional share price appreciation. PMD doubled off the March 2009 panic low, but has been a disappointing long-term holding. The company's patented process of drug testing with hair samples did not prove as resilient through the recession as we had hoped. Despite a solid customer base among corporate customers, government institutions and schools and a seemingly superior product, the shares did not keep pace with our expectations. TROW embodied the investment plan when we designed our Small-Mid Core product: buying smaller companies and holding them as they move up the capitalization ranks. First purchased in early 2000, the company at the time was approximately a \$3 billion company. The company executed on its growth strategy well during the decade and recently had a market capitalization of over \$13 billion. The stock trades at a premium valuation, however, and competition in its 401(k) business is intensifying. We felt it was prudent to recognize the gain. WEYS designs and markets highly regarded footwear under the Florsheim, Stacy Adams and Nunn Bush brand names. WEYS operates in the United States, Canada, Europe, Australia, South Africa and the Far East. The business has transitioned from being a standalone retailer to being a wholesaler supplying specialty stores, department stores and clothing retailers. The Florsheim family owns more than 30% of the company's outstanding shares, ensuring alignment of management and shareholder interests. Family ownership also insures an attractive cash dividend, and the company's dividend history is unusual for small companies – increasing its dividend payments over the last 10 years. The company has ample cash, no debt and attractive valuation.

* It should not be assumed that recommendations made in the future will be profitable or will equal the performance of these securities. A list of all securities purchased in the portfolios during the past year is available upon request by calling 415-869-6379.

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