

ACWI ex-US Value Equity Management

First Quarter 2008 Investment Commentary



Investment Environment

Global stock markets started 2008 with their worst quarterly performance in nearly five years. The credit crisis deepened with the collapse of Bear Stearns, forcing the Federal Reserve Bank to take unprecedented action by sponsoring a fire sale to JP Morgan. European banks announced another rash of asset write-downs; the most recent at UBS totals \$18 billion and will require \$13 billion in new equity to shore up the bank's capital position. The Fed also moved aggressively to inject more liquidity into the system. US interest rates were cut 200 basis points to 2.25% over the period, sending the dollar down approximately 10% versus the euro and yen. The UK sterling has suffered from a weak housing market similar to the US. At the same time, commodity prices continued to surge, with oil exceeding \$110 per barrel, gold hitting \$1000 per troy ounce and agricultural product prices showing no signs of relief. The US shed 63,000 workers in February, its highest monthly loss in five years. The ECB kept rates on hold, but will likely intervene if further euro strength damages the critical export sector. Japanese consumer confidence declined nearly 4%, reaching its lowest level since 2003, adding further pressure the market's dismal performance.

Portfolio Performance Review

The ACWI Ex-US Value strategy underperformed its benchmark (based on net-of-fees performance), the MSCI ACWI ex-US Index, during the first quarter. In stark contrast to previous bear markets, value is performing poorly. We expect this to reverse as investors begin searching for investment ideas with limited price risk.

Country Review

Europe

Germany – Germany industrials sold off sharply as the euro advanced during the quarter. The company's leading semiconductor company reported below expectations and lowered 2008 revenue guidance for the communications division. Wage inflation is also weighing on the market, which has benefited from unprecedented restructuring over the past few years.

UK – Disappointing holiday sales hit the beleaguered UK retail sector and a pullback in January oil prices caused profit-taking in energy names. Energy stocks have since stabilized as oil prices hit record levels. Metal stocks held firm on the back of consolidation and emerging markets demand, but commodities did begin to demonstrate nascent signs of weakness as the quarter closed. A prolonged credit crisis will clearly reverberate to emerging markets, the main consumer for global commodities.

Italy – Italy's largest financial services company declined in sympathy with the industry as its incumbent telecom operator was forced to cut its dividend to pay down debt.

Asia

Japan – Deteriorating domestic conditions, US economic weakness, yen strength, and a lackluster earnings season destroyed any remaining optimism in the Japanese market this quarter. To put the currency in perspective, Japan fell 16% in local currency and 6% in US dollars. This creates a major headwind for exporters, the pillars of Japan's economic power. Many companies assume 100 yen to 1 US dollar, a conclusion that could lead to double-digit profit across exporters.

China – After an explosive rally in the Chinese market from the end of August 2007 through October 2007 which saw many large H share securities double, China shares were among the worst performers during the first quarter of 2008. With the H share market down nearly 24% in USD terms, our portfolio's underweight stance was beneficial. China delivered 11% GDP growth in the fourth quarter of 2007, and despite concerted efforts to contain growth, the People's Bank of China has scant control over expansion. Inflation, though mainly driven by skyrocketing food prices, continues to be a serious concern for the central government and investors alike. The recent unrest in Tibet threatens to tarnish the upcoming Beijing Olympics, so all eyes are on China's handling of a difficult situation.

(Continued on next page)

ACWI ex-US Value Equity Management

First Quarter 2008 Investment Commentary

India – The Indian market was one of the few which weakened throughout the quarter, including February. Its market declined by nearly 27% in USD terms, after holding up very well during the initial stages of the emerging markets sell-off back in November and December of last year. Inflation continues to be an ongoing concern, while generally, countries which are running fiscal deficits (including India) have underperformed due to concerns of a global economic slowdown. India's budget appears benign, with special attention devoted to the agricultural sector, which supports 60% of the population. Fertilizer subsidies and debt "forgiveness" were the main points, which should benefit banks and agricultural stocks. With valuations becoming much more favorable due to the correction, we have recently sourced new ideas for the portfolio.

Taiwan – Taiwan closed out the quarter as the best performing large market, up over 5% during the period. The market sustained solid performance throughout the quarter which was spurred by January's positive legislative election results. The opposition party, KMT, won convincingly in January, then followed up with a decisive win in the Presidential Elections in March. The KMT party is expected to pursue deeper business ties with mainland China, a marked departure from the DPP position. Business friendly political change should open mainland China to Taiwanese businesses thus far restricted from outsourcing more than 25% of production. The initial euphoria drove domestic oriented shares such as financials, real estate and consumption oriented companies up strongly. The technology sector then followed suit after DRAM manufacturers announced they would increase prices for DRAM memory by as much as 20% this year. Taiwan's leading economic indicators indicate that the country's economic correlation with the US could be moderating.

Sector Review

Financial Services – The failure of Bear Stearns compounded the pressure on bank stocks. Further write-offs are likely in Europe, particularly among the large investment banks. Japanese banks have negligible exposure to securitized debt and are somewhat defensive, but they remain hampered by dull credit demand. Central banks have injected liquidity to spur overnight lending, but many European investment banks are struggling to offload loans made in LBO deals. Not surprisingly, banks are reluctant to extend credit in such an uncertain environment.

Information Technology – Technology declined on disappointing earnings reported by companies that service the telecom industry. There have been delays in major network expansion projects in some countries.

Materials – After slipping toward the latter part of 2007 and January 2008 on fears of a global economic slowdown, metals and mining securities within the Materials sector were once again in the spotlight. A wide array of hard and soft commodities surged in February; gold reached a milestone \$1,000 per ounce. Towards the end of the

quarter, there was a noted change in leadership, with investors rotating into paper and chemicals from mining stocks.

Consumer Staples – Defensive by nature and highly exposed to the growing emerging market consumer, Consumer Staples held up better than the market during the quarter.

Country Allocation Review

Country allocation was flat during the first quarter, helped by an overweight position in Japan, which gained on the yen translation, and emerging markets. Less exposure to Australia also delivered a positive allocation effect.

Sector Allocation Review

Sector allocation was also flat, helped by our overweight stance in consumer staples and healthcare, both considered defensive sectors.

Looking Forward

Global equities reacted swiftly to the credit crisis and could be nearing an inflection point. Capital markets are generally leading economic indicators and tend to turn before GDP growth shows signs of a recovery. The Federal Reserve Bank has boosted liquidity in the US, which should stimulate growth when complemented by upcoming tax relief and a surge in exports. The ECB has been reluctant to aggressively support the banking sector or cut interest rates. However, the euro is a burden on exporters, core inflation is below target, and credit is very tight. The corporate sector will be looking to the ECB to provide some relief before currency headwinds become too severe. Japan remains highly correlated to external demand, albeit the US has become a marginal trading partner when compared to China. Like Europe, Japan is feeling the effects of a yen rally. The Bank of Japan is expected to cut rates 25 basis points at its next meeting. Consensus opinion is calling for below trend growth in 2008, with the US leading Europe on the recovery path. Nevertheless, liquidity measures and low valuations could help equity markets stage a rebound before G7 economies begin to expand again.

In this scenario, value should take a more prominent role in delivering alpha, as has been the case in previous cycles. Momentum is unusually robust during this bear cycle and appears ready for a reversal. This backdrop is favorable for our investment strategy, which tends to overweight value and underweight price momentum.

Europe

Major headwinds are at work in the UK including the banking crisis, stubbornly high household costs, and risk to employment if financial conditions do not improve. As expected, The Bank of England cut interest rates by 25 basis points in April, citing the ongoing problems in credit markets and potential growth headwinds. Look for rates to hit 4.0% over the next year, as retailers continue to reduce 2008 expectations due to dismal consumption trends.

(Continued on next page)

ACWI ex-US Value Equity Management

First Quarter 2008 Investment Commentary

Continental Europe has staged a relief rally since bottoming in mid-March. This could be short-lived, as it may be difficult for the area to meet 7% earnings expectations when profits are already at peak levels, exports are down, the banking system remains paralyzed, and consumer sentiment is waning. Euro resilience has a dual impact on the region's economic growth. Clearly, it has hit the export sector sharply, particularly in Germany. It has also kept inflation in check, which could provide the ECB some latitude in reducing rates in the second half of the year. A reflationary backdrop in Europe and the US could jump-start the economy later this year. However, we are cautious in the near-term as many companies could begin to lower 2008 guidance. This would trigger a wide range of downgrades to the 7% growth estimate.

Asia

Japan's domestic economy has made no progress in making a greater contribution to GDP growth. Without strong domestic consumption, the country remains vulnerable to external demand weakness. The most recent Tankan business survey deteriorated more than expected and the yen has surged relative to the US dollar, a major obstacle to export resiliency. The Bank of Japan will likely keep rates on hold, as real rates are already negative. Despite this precarious situation, domestic plays should actually outperform exporters due to valuation support, notwithstanding a lackluster local economy. The banks have already staged a rally due to fallout in Europe and the US. Japanese banks do not have exposure to the sub-prime mess and have actually picked up some lending activity that would normally take place overseas. Japan does provide some defensive characteristics: employment is solid, which should lead to wage inflation; consumer and corporate balance sheets are cash rich; and 60% of the market trades below book value.

Latin America

Rising inflation and weak US demand could create headwinds for Latin America. Rising costs will constrain monetary policy leading to lower GDP growth versus 2007. Mexico is clearly the most vulnerable to a US slowdown, and we have already observed a fall in remittances in export activity. However, public spending and tax reform could help offset these factors. Brazil is more optimally positioned due to rising wages and the lag effect of monetary easing. Once heavily dependent on the commodity cycle, Brazil's local economy is set to take a larger role in the country's growth. This thesis may be tested later in 2008 as Brazil's central bank considers raising interest rates in upcoming policy meetings to offset moderately rising inflation expectations.

EMEA

Inflation is the main risk facing Central Europe, with policy reaction varying by country. In Poland, local demand is robust and inflation is rising. Fiscal stimulus should keep growth in line with 2007, causing inflation to remain high. Hungary is dealing with lackluster growth and a current account deficit. The country is growing at 2.5%, below its 4% potential. Domestic demand in Turkey has fallen as higher

interest rates have curbed spending. Although an extended period of lower inflation appears more realistic, falling wage costs will likely suppress consumption in the near-term. The political uncertainty surrounding the Turkish military's recommendation to the High Court to ban the AK Party, including PM Erdogan and President Gul, a party which recently won 47% of the popular vote, will also weigh on the market for some time. Russian consumer confidence and oil prices should support further expansion in 2008. President Putin did not alter the constitution to eliminate presidential term limits. He did, however, anoint his successor and agree to assume leadership of the United Russian party. As a result, he will be viewed as the de facto head of Russia. The election visibility has actually added to consumer optimism. Measured rouble appreciation should continue in 2008, but a fully floating currency is not expected. Liquidity will stay high, as the government is intent to keep expansion on track despite higher prices. South Africa has enjoyed a relatively long period of domestic consumption strength. Inflation is stubbornly high at 7%, which will lead to higher rates and a period of weak domestic demand.