

Dynamic Value Equity Management

First Quarter 2008 Investment Commentary



Investment Environment

As we entered 2008 there were clear indications of severe stresses on the US financial system. The collapse of the mortgage market claimed more victims, as Bank of America (BAC) stepped in to purchase the portion of Countrywide Financial (CFC) it didn't already own; Swiss banking giant UBS (UBS) and insurer American International Group (AIG) each took write-downs of more than \$10 billion; both Citigroup and Merrill Lynch sought capital infusions from foreign governments; and Bear, Stearns (BSC) imploded, forcing a hastily negotiated (and just as hastily renegotiated) fire sale to JP Morgan Chase (JPM). Late in the quarter Standard & Poor's, having lowered its ratings on over eight thousand mortgage-related debt issues, upped its forecast for total losses in that area of the fixed-income market from \$265 billion to \$285 billion. And in an effort to keep the US financial system from seizing up completely, the FOMC cut the Fed Funds rate by 2%, to 2.25%, funded JP Morgan's buyout of Bear, Stearns, and announced a \$200 billion short-term lending facility, which it made available to both commercial and investment banks.

The broader US economy also showed signs of strain. In January's final week unemployment claims surged by 69,000, the highest one-week rise in a decade, and February's employment report, noting 63,000 job losses, was the worst in five years. There was mounting evidence of a pullback in consumer spending; for January, retailers posted their worst monthly sales report in five years, and service sector activity hit its lowest level since 2001. Reporting its fourth quarter results, GM posted a full-year 2007 loss of \$38.7b, believed to be the largest ever for an automaker. The decline in housing prices accelerated, overall consumer spending was flat after adjusting for inflation, and consumer confidence fell sharply, to levels seen only in past recessions.

In dollar terms, everything from wheat and oil to gold and the euro rose to new highs, heightening concerns that inflation would hamstring the FOMC's attempts to jump-start the economy by lowering interest rates even further. With the Fed cutting its outlook for growth and with reported CPI rising at a 4.3%

annual rate, the term "stagflation" re-entered the economic lexicon.

On the political front, the Presidential primary season got underway and, in spite of political unrest in Pakistan and Kenya and continued provocative behavior from North Korea and Iran, the focus shifted quickly from national security and foreign policy to economic issues. In Washington, the House and Senate approved a \$168b fiscal stimulus package of rebates and tax breaks proposed by President Bush, who also filed a fiscal 2009 Federal budget in which total spending topped \$3 trillion dollars for the first time.

A few glimmers of silver did appear at the edges of the storm clouds this quarter. VISA's (V) IPO was priced above its expected range and rose sharply on its first day of trading, providing a windfall for the consortium of banks which own a majority of the shares; Microsoft's (MSFT) offer for Yahoo! (YHOO) and Electronic Arts' (ERTS) bid for Take-Two Interactive Software (TTWO) were the most visible but by no means the only indications that corporate managements are seeing compelling values in current equity prices; and, in what historically has been a consistent indicator of positive stock market return for the year, the NFC's New York Giants won the Super Bowl.

Not surprisingly, economic uncertainty translated into equity market volatility. In late January and again in mid-March, FOMC stimulus reversed the direction of a sharply declining stock market; however, both ensuing rallies were short-lived, and most broad indices up and down the capitalization spectrum ended the quarter with close to double-digit losses. From a style perspective, large cap value modestly outperformed growth; the spread was significantly wider in small cap stocks.

Portfolio Performance Review

The Dynamic Value Equity portfolio produced solid outperformance of the Russell 1000 Value during the first quarter of 2008, despite the volatile US equity markets (based on net-of-fees performance). The benchmark produced

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negative returns in every sector during the quarter as the current macro headwinds weighed on the market. However, the portfolio was able to protect its value on a relative basis in the down market. Essentially all of the portfolio's relative outperformance was driven by stock selection. Additionally, seven of ten sectors outperformed the benchmark as we continued to use our deep fundamental resources to find stocks at the intersection of valuation and business momentum.

Sector Review

Energy was the top performing sector. The portfolio was modestly underweight; but within the sector our overweight position in natural gas stocks pushed total return for the entire sector into positive territory on an absolute basis. We continue to find attractive natural gas stocks with good valuations and solid business momentum that is driven by the industry's supply and demand characteristics.

The Industrials sector was the weakest performer as our modest underweight as well as stock selection hurt performance. Our underweight position in a large market cap industrial name that outperformed the sector was the largest negative contributor to the overall portfolio in the quarter.

Importantly, despite the continued market turmoil, the financials sector modestly outperformed during the quarter. We continue to look for attractive financial stocks where we have a high degree of confidence in valuation and some early signs of business momentum, but remained underweight during the quarter.

Looking Forward

As we have witnessed the deeper and broader effects of the mortgage and housing crisis over the past three months, we have come to believe that the most likely scenario for the US economy is a short, shallow, but statistically measurable recession in the first half of 2008. While the Fed's aggressive efforts and creative new approaches in providing liquidity to the financial system, and investor perception that the Fed will continue to do "whatever it takes," have prevented the credit markets from seizing up entirely, the rational reluctance of financial institutions to take on additional risk during this period of financial stress will cause a lag in the flow of that liquidity through to both commercial and individual end users. In addition, the negative effects of housing price deflation and of continued high commodity prices are likely to act as a drag on economic growth, not just for the next few months but probably for a long time after the current slowdown, resulting in an extended period of subpar economic growth.

While the profit outlook for financial stocks remains uncertain as the credit crunch continues, other high quality large cap equities have shown only limited profit weakness so far in a context of continuing global expansion. Many of these stocks are now offering higher yields than Treasury bills and other money market investments, and demographic trends should start to raise the scarcity value of companies which offer both more stable earnings growth patterns and

the prospect of rising dividends over the next decade or more.

Finally, the stock market is a leading indicator and not a coincident indicator of economic activity. It usually declines late in an expansion and early in a recession as profit weakness is first anticipated and then announced; the market usually completes its decline late in a recession and starts to rise again as conviction spreads that an easy monetary policy has had the desired effect and investors start to discount future economic recovery. While not attempting to "call the bottom," we believe that the appropriate approach to investing in US large cap equities is to remain fully invested and to continue an ongoing process of positioning our portfolios to benefit from the extended but relatively slow-paced economic recovery which we expect will begin later this year.