

# International Core Equity Management

## First Quarter 2008 Investment Commentary



### Investment Environment

The investment climate at the beginning of the quarter was poor at best, and it proved to be a most difficult quarter for global stocks. The major indices, FTSEurofirst 300, MSCI EAFE, MSCI Japan and the S&P 500, reported their worst quarterly return in over five years. Stresses in the financial market escalated as several industry giants announced significant losses. The collapse of Bear Stearns in the US was the most notable. 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 the bank's capital position. US interest rates were cut to 2.25% over the period, sending the dollar down approximately 10% versus the euro and yen. Commodity prices continue to surge and agricultural product prices show no signs of relief. Japanese consumer confidence declined nearly 4%, reaching its lowest level since 2003, adding further pressure on the market's dismal performance. At the end of the quarter, there was some good news for investors as JP Morgan, with a loan from the Fed, was able to buy out Bear Stearns at a more reasonable price than initially offered. The FOMC, in an effort to inject liquidity and buoy the struggling banking sector, cut the Fed Funds rate from 3% to 2.25% and announced a \$200 billion short-term lending facility which it made available to both commercial and investment banks.

### Portfolio Performance Review

For the quarter, the portfolio underperformed its benchmark, the MSCI EAFE Index (based on net-of-fees performance). While we have not seen a repeat of quantitative models being as severely impacted as we saw in the second half of last year, the market was very volatile and price momentum was running. Stocks that were rising continued to rise and those that were falling continued to be sold off. Recently we have seen the efficacy of price momentum, which has hurt us, is slowing. It is believed that hedge funds cash positions are at all-time highs. There is a general acceptance that hedge funds as a group and quantitative strategies, for the most part, are long the cheap stocks (i.e. low P/E, P/B), and short the expensive ones. As we are long "cheapness", we are harmed as these firms unwind their positions to de-lever. It is a short-term

phenomenon that should recede as the markets find "direction". Growth has continued to outperform value this quarter, creating a modest head wind for our strategy. The widening of valuation dispersion from historically low levels that began in the third quarter of 2007 has continued, impacting stocks with a value component. However, spreads are now higher than average, leading us to believe we are very near the end of the adjustment phase for the markets and our quantitative model.

### Country Review

For the quarter the, UK and Japan had the largest negative contribution to the portfolio return. These two countries, approximately 43% of the capitalization in the EAFE Index, are experiencing a weakened real estate market, a credit crunch impeding financials, consumers cutting spending and exposure to the economic health of US. Within both the UK and Japan, stock selection in the financial and consumer discretionary sectors was weak. Japan, typically a value driven market, recently became an "anti-value" market driven entirely by price momentum, which we believe will not continue. Germany and Switzerland were positive contributors to the relative return. In Germany, the portfolio benefited from exposure to German steel companies. In Switzerland, the portfolio had a positive contribution from the financial sector, as we avoided some of the more beaten down stocks and our overweight in Swiss insurance companies helped.

### Sector Review

The Consumer Discretionary sector was a major source of the underperformance, responsible for over 60% of the relative return. Household durables, along with leisure equipment, had the largest impact within the sector. Following the surprise interest rate cut in January, the yen strengthening vs. the US dollar had a material effect on Japanese consumer stocks; several well ranked Japanese exporters were sold off with expectations of earnings being hit by foreign exchange adjustments. As the UK consumer has been impacted by housing sales deteriorating along with rising food and gasoline prices, spending is down, making our exposure to the UK retail

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sector a negative. The Healthcare sector was also a negative contributor to the portfolio. In the healthcare equipment group, a Japanese stock with an exposure to export consumer goods was sold down on weak US sales. Our underweight to large-cap pharmaceuticals was negative, as they benefited from the perception of defensiveness, despite peer fundamentals. In the Financial Sector, as write-downs continued to surprise investors, commercial banks underperformed. The portfolio saw strong performance in Consumer Staples. The beverages group, exposed to the growing emerging market consumers, performed well. Food product stocks performed well as companies have been able to pass along the price increases in agricultural raw materials to the consumer.

### Looking Forward

Reuters reported on March 31 results of a survey showing that, in the near-term, seven out of ten money managers around the world expect a US recession. The US Fed has taken a strong stance to stabilize the market and investors will continue to look there for direction; however, the financial institutions are reluctant to take on additional credit risk, and this will cause a lag in the flow of capital to both commercial and individual end-users. As the housing slump continues and the price of goods and raw materials rise, inflation is a worry. On the positive side, credit markets have shown some signs of stabilization, markets are down from recent peaks and valuations are attractive. We will continue to manage the portfolio using our time-tested disciplined approach of choosing stocks with attractive valuation and positive business momentum.