

International Small Cap 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, S&P Citigroup EMI ex US 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 up 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 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

The International Small Cap Equity strategy underperformed its benchmark, the S&P Citigroup EMI ex-US Index, during the quarter; however, all of this underperformance came in January when the portfolio underperformed the index by 2.1%. The portfolio came back in February and March and outperformed in each month, which leaves us to believe we may be at the end of the adjustment period for quantitative models. In January, the model, as seen in the second half of last year, continued with perverse behavior as the top three deciles, our most attractive stocks and where we are the most exposed, underperformed the benchmark. Deciles 7-9 outperformed the benchmark. This was not the case in February and March as there was positive allocation to the model; however, the

damage had been done. During the quarter, we became more defensive and reduced our exposure to the hard-hit Asian real estate sector. We continue to monitor our overall portfolio beta, making adjustments as necessary to maintain a neutral stance. (All data is based on net-of-fees performance.)

Sector Review

The Financials and Industrials sectors, the two most impacted by a rollover in the cycle, were the poorest performing for the quarter, contributing more than 100% of the negative relative return. In Financials, the quantitative model was not helpful as the top deciles underperformed the sector return. Companies exposed to real estate management did poorly. In Industrials, given the economic slowdown, the electrical equipment, machinery and trading companies underperformed, with the attractively ranked stocks being impacted. With commodities soaring, the Materials sector outperformed; metals and mining did well.

Country Review

Japan was the poorest performing country as it underperformed the Japanese index by 4%. Japan, typically a value driven market, recently became an "anti-value" market driven entirely by price momentum, which we believe will not continue. The industrial stocks, hit by a decline in future construction contracts, were impacted. The real estate management stocks underperformed. In Spain, the portfolio underperformed with industrials having the biggest negative impact. Hong Kong was a positive contributor to the relative return as financials performed well, and our underweight to consumer stocks was positive. Resource rich Australia outperformed as the materials sector was positive.

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.

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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.

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