

US Large Cap Core 130/30 Equity Management

First Quarter 2008 Investment Commentary



Investment Environment

The first quarter of 2008 dawned with clear indications of some growing stresses in the US financial system as several industry giants announced significant sub-prime-related write-downs and experienced capital shortages. The most notable drama to have evolved from the sub-prime debacle thus far was the implosion of Bear Stearns, which was rescued by a government-backed JP Morgan buyout. In an effort to boost liquidity and buoy the struggling banking sector, the FOMC cut the Fed Funds rate by 2% (to 2.25%) 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 weakness – unemployment numbers increased in pockets and the residential real estate market continued its wide-spread struggles, resulting in flat consumer spending (adjusted for inflation) and falling consumer confidence. In US dollar terms, everything from wheat and oil to gold and the euro rose to new highs, heightening concerns that inflation would hamstring the Fed's attempts to jump-start the economy by lowering interest rates further. With the Fed cutting its outlook for growth and with the reported CPI rising at a 4.3% annual rate, the term "stagflation" re-entered the economic lexicon.

All is not doom and gloom, however. As numerous as the negative statistics are, the system is strained, but not broken. The Fed has responded in proportion to the threat, and, in pulling levers beyond standard monetary policy, has targeted the nature of the threat by reinforcing confidence in the system itself. Moreover, some encouraging indicators speak to the resiliency of the economy. While gasoline and crude oil prices have sky rocketed (up more than 30% and 50% respectively in the last year), and food costs have increased as well, the Core CPI number at 2.3% year over year would indicate price levels of many other daily consumer goods and services have held steady or even declined. Unemployment has begun to rise, but is hovering around 5% - a healthy level. The weak US dollar creates disadvantages, but has helped to boost exports and narrow the current account deficit. While some major deals have gone off track for lack

of financing, attractive valuations continue to drive M&A activity.

Not surprisingly, this conflicting information has translated into increased equity market volatility. In late January and again in mid-March, Fed 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 near double-digit losses.

Portfolio Performance Review

Despite a perilous investment environment, our Large Cap Core 130/30 portfolio outperformed its S&P 500 benchmark in the first quarter of 2008 (based on net-of-fees performance). It will likely come as no surprise that our short positions contributed significantly to returns during the period. Value-added on the long side was limited to four out of ten sectors; however, our long positions outperformed shorts in five of the nine sectors where we had short exposure.

Sector Review

Healthcare led net sector returns (incorporating long and short) with an active return of 77 basis points. We did suffer some "headline risk" set-backs in pharmaceutical stocks, but our underweight to the industry helped, as did our preference for medical products and hospital supply companies.

Strong stock selection in the Energy sector contributed 38 basis points to active return, with some of our biggest contributions coming from the drilling and servicing area. It also bears mentioning that we added value in Financials, with strong defensive positioning cushioning the portfolio from the worst of recent turmoil.

Industrials brought down performance, costing us 58 basis points relative to the S&P 500. There were no major disappointments involved, mainly a situation where some of our biggest winners from last year gave a little back. We remain comfortable, nonetheless, with our stock choices in this sector.

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Materials stocks continued to be volatile as investors tried to reconcile slowing economies in the developed world, alongside some precedent-setting run-ups in commodities pricing, against the potential for long-term growth in China, India, and the developing countries. We lost 22 basis points versus the benchmark in this sector.

Looking Forward

As we have observed 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. Recovery, however, will take time to play out, with potential for reversals in the early stages. The Fed's aggressive efforts and creative new approaches have helped to prevent the credit markets from seizing up entirely, and accelerated the timing of a turn-around. However, the reluctance of financial institutions to take on additional risk during this period of financial stress will cause a lag in the flow of capital to both commercial and individual end-users. In addition, the negative impact of house price deflation is likely to create an obstacle to short-term economic growth.

At this juncture we remain defensive, but are ready to shift positioning as signs of stabilization and early recovery emerge. Financials stocks are at historically low valuations, and while the profit outlook for these companies remains uncertain, many firms are taking appropriate remedial action and shoring up their capital bases. We are also following consumer companies whose sales and margins are stabilizing and poised for recovery.

We also see potential to gain from well-timed moves in Technology. After a momentum-driven 2007, many 2008 estimates for technology firms were built on extremely optimistic sales and margin expansion assumptions. As a result, we began this year with a defensive underweight. Here again, valuations are becoming very attractive, and we will be carefully looking for the right re-entry opportunities as they present themselves.

It is virtually impossible to "call the bottom" in a market such as this; we believe that changing course too early would open the portfolio up to excessive risk. Thus, we will continue in our defensive stance even as we watch for opportunities in the way of companies that can buck the downward trend and those that are poised to benefit from recovery.