

US Large Cap Core 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 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 that the 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, the conflicting information mentioned above translated into increased equity market volatility during the quarter. 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

The US Large Cap Core strategy slightly underperformed its benchmark, the S&P 500 Index, during the first quarter of 2008 (based on net-of-fees performance). The underperformance was due to moderately weak stock performance in the Information Technology, Consumer Discretionary and Industrials sectors. Interestingly, these were the three biggest drivers of last quarter's outperformance.

Sector Review

The culprits for the strategy's underperformance during the quarter were the Information Technology, Consumer Discretionary and Industrials sectors. Information Technology was one of our most significant contributors to outperformance during the fourth quarter and throughout 2007, but several of our biggest winners stumbled and took their toll on the portfolio this quarter. Specifically, it was weak performance in the computer industry that bogged down the sector. The portfolio was overweight the Technology sector for much of 2007 due to attractive relative valuations and growth prospects. Nevertheless, as the appeal of the tech space diminished, we systematically took profits, eliminated our overweight during the fourth quarter, and maintained that underweight for the last three months. Similar to the technology space, lagging performance in the Consumer Discretionary sector was concentrated in one sub-industry – consumer services. In fact, one stock accounted for the entire negative attribution effect that befell the sector. Lastly, in the Industrials sector, it was our lack of exposure to road, rail and air freight companies (all of which fared well) and poor

(Continued on next page)

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stock performance within airlines that detracted from performance in the first quarter.

Off-setting much of the sub-par performance described above were the Energy and Consumer Staples sectors. Our holdings in both oilfield services and E&P (exploration and production) companies, along with a lack of exposure to several of the larger integrated oil firms (which suffered from paper-thin refining margins), helped to drive the Energy sector's positive relative returns. Consumer Staples was the best-performing sector on an absolute basis, which is no surprise given the recent pullback in discretionary spending. On a relative basis, the sector was led by holdings in the food & discount retailer and drugstore space, all which performed well 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. Recovery, however, will take time to play out, with potential for reversals in the early stages. We believe 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 effects of housing price deflation is likely to act as an obstacle to short-term economic growth.

Given some of the over-arching themes in the marketplace, there are a few areas on which we are keeping a watchful eye. After a momentum-driven 2007, many 2008 estimates for technology firms were built on extremely optimistic sales and margin expansion assumptions. While we began the first quarter with a defensive underweight, we are very carefully looking for the right re-entry opportunities as they present themselves.

The Healthcare sector is also dealing with notable headwinds, such as the prospect that many notable patent expirations are due to occur in the next several years. Furthermore, election year rhetoric regarding the potential nationalization of certain aspects of the industry is approaching a crescendo, and the team believes that some volatility will result. As a result, our focus continues to be on the hospital supply companies and not on the pharmaceutical or management firms.

Two recently beat-up areas that we are finding increasingly attractive are financials and consumer stocks. While the profit outlook for financial stocks remains uncertain as the credit crunch continues, valuations are becoming incredibly attractive and firms are shoring up their capital base. Within the consumer sectors, we are focusing on

value with respect to strong sales, stable or expanding margins and, ultimately, earnings; we continue to avoid companies that are experiencing noticeable margin contraction.

While it is virtually impossible to "call the bottom" in a market such as this, we believe that it is in our investors' best interest to position the portfolio in such a way as to be prepared for recovery when it turns the corner. We hope to accomplish this by taking advantage of short-term market downturns to establish positions in stocks with solid medium and long-term growth prospects.