

US Mid Cap Growth Equity Management

First Quarter 2008 Investment Commentary



Investment Environment

The first quarter of 2008 witnessed an acceleration of the severity of the problems lingering from 2007, and clear indications of severe stresses in the US financial system. The US dollar, which struggled against the euro last year, experienced significant weakness against all major currencies during the March quarter. Credit and valuation problems in the sub-prime mortgage area produced far-reaching effects throughout the financial system worldwide and cast a pall over the US and global equity markets in general. Write-offs at commercial banks, insurance companies and investment banks increased significantly, and several financial institutions were forced to seek additional capital, most notably by turning to sovereign wealth funds. Eroding confidence and solvency questions caused the credit markets to demand higher spreads over Treasuries and caused selected markets (auction rate notes) to “freeze up.” Those factors also assisted in the near bankruptcy of Bear Stearns which buckled under the weight of a modern day version of a “run on the bank”, forcing a hastily negotiated (and Federal Reserve brokered) fire sale to JPMorgan Chase. The restrictive credit environment, higher energy costs and declining home values dampened consumer spending during the period. The current slowdown in consumer spending, which accounts for two-thirds of US GDP, has placed heavy downward pressure corporate profits and the broader economy. Commodities continued to soar, with soft commodities such as corn, soybeans, and wheat all reaching record prices during the first quarter, as did hard commodities such as oil and gold, although each has pulled back since.

The difficult credit markets and economic slowdown had an overwhelming negative influence on equity markets. All of the broad US Equity indices fell during the quarter, with no safe haven across market capitalizations, as the small-cap oriented Russell 2000 Index fell 9.9%, the Russell Mid Cap Index dropped 10.0% and the large-cap oriented S&P 500 declined 9.9%, its worst quarter in over five years. In this challenging environment, value stocks outperformed growth stocks across the spectrum of small, mid and large capitalization stocks. From a sector standpoint, nine of ten economic sectors in the Russell 2000 Index

showed negative returns (only the Energy sector showed a small gain), and all ten sectors of the Russell Mid Cap Index and the Russell 100 Index produced negative returns. On the positive side, both the Federal Reserve and Federal Government have acted with unprecedented quickness to provide monetary and fiscal stimulus to blunt the effects of the downturn. Over the last three months, the Federal Reserve lowered the Federal Funds target rate by 200 basis points and implied a willingness to go lower if needed. Washington has just enacted a fiscal stimulus plan in excess of \$160 billion that will attempt to rejuvenate consumer spending through the use of a direct payment of up to \$600 per qualified individual. While the benefits of the actions remain to be seen, the speed at which the actions have been taken is heartening. Also benefiting the economy has been the growth in exports. The broad weakness of the dollar has created meaningful cost and pricing advantages for companies with domestic production and dollar pricing.

Portfolio Performance Review

The US Midcap Growth Equity strategy underperformed its benchmark, the Russell Midcap Growth Index, during the quarter (based on net-of-fees performance). The continued downward pressure of the broad decline throughout US equity markets especially hurt a number of portfolio companies, despite solid earnings fundamentals. Investors in this environment remain focused on the very short term earnings landscape, and seem unwilling to look further out as a lack of confidence in the overall economy has shortened their horizon.

Sector Review

The portfolio was positively impacted during the quarter by exposure to the Materials, Utilities and Healthcare sectors. Within Materials, our exposure to the containers and packaging segment drove our relative performance. This was led by an investment in a maker of glass containers and specialty packaging materials that surged after posting earnings which exceeded analysts' expectations. The company improved through manufacturing efficiencies, operating cost improvements, pricing discipline and

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procurement initiatives. Free cash flow was higher than expected and could double over the next year or so, positioning the company to meaningfully further de-lever the balance sheet and engage in acquisitions.

Within Utilities, our sole exposure to a diversified natural gas utility rose on strong fourth quarter earnings and higher 2008 profit expectations. The company is benefiting from rising natural gas prices and increased production from their E&P operations.

The portfolio adopted an overweight position relative to the Healthcare sector during the quarter, and outperformed the benchmark with investments in the pharmaceuticals and life sciences tools and services areas. Within the pharmaceuticals area, several names held up well, including a biopharmaceutical company specializing in products focused on urology and sexual health, as well as a specialty pharmaceutical company, that posted fourth-quarter results above estimates, driven by a jump in revenue from its pain reliever drug. Within the life science tools, an investment in a global life sciences company providing products and services for the development of drugs and the diagnosis and treatment of diseases, was higher on strong operating results and better visibility going forward. An investment in a global contract research organization rose on healthy fourth quarter earnings, characterized by strong bookings and backlog growth.

Conversely, the portfolio was most negatively impacted by investments in the Industrials, Telecom Services, and Consumer Staples sectors. Within Industrials, the commercial services and supplies segment was the portfolio's biggest detractor. Our long-term investment in a print and visual communications services company reported a decline in profit even as sales grew. The lack of earnings leverage combined with the company's health debt load and a slowing economic backdrop led us to sell the stock. Within the machinery segment, an investment in a manufacturer of commercial food service and food processing equipment fell as investors became concerned over the economic outlook and durable goods orders dropped in a government release in late March.

Our Telecom Services exposure was hurt by an investment in an American company that runs Latin American wireless communications networks. Despite reporting higher profit for its fourth quarter on subscriber additions and giving a strong fiscal 2008 forecast, the stock declined as investors focused on temporary increases in competitive behavior and the announcement of a technology transition to 3G services. The company remains well capitalized, generates some of the best returns in the region, and should sustain superior revenue and cash flow growth into the future. Finally, the Consumer Staples sector hurt on a relative basis as our investment in the biggest US dairy producer saw fourth-quarter profit tumble due to surging raw milk costs and a glut of organic milk. However, we believe input cost inflation will be temporary and forward looking earnings prospects for the company are attractive.

Looking Forward

As we move through 2008, we anticipate continued high volatility. We expect the market will be challenged by many of the current issues and could experience new challenges, such as rising unemployment as companies seek to reduce costs as well as inflationary pressure in light of rising prices. However, the market should begin to discount the benefits of the fiscal and monetary stimulus, a pending recovery in corporate profits and improvement in investor sentiment. We expect the continued volatility will create several outstanding investment opportunities and are confident our investment process will capitalize in this environment.

We are in-line relative to the benchmark in the Information Technology sector. Our emphasis is focused on companies that have low technological obsolescence risk, a strong product or servicing position, and are priced at an attractive valuation relative to their earnings capability. We remain diversified across the sector and continue to believe that, as companies move toward higher capacity utilization and face slowing productivity growth, an emerging upgrade cycle will drive increased demand for technology related products and services. Further declines in a difficult first quarter offer deeper compelling valuations relative to their growth, and share prices could rise as industry fundamentals improve. We have focused on a number of companies in the sector that have solid prospects for strong earnings growth. Our larger exposures remain within the semiconductor, software, and IT Services.

The Healthcare sector remains a fertile area of investment opportunity for the portfolio and we are overweight the group. This sector should be less impacted by the slowing US economy and benefit from the broader themes that can continue to drive growth: the aging of the baby boomer population, improved patient care, and reduced overall healthcare expenditures for the government, providers, and patients. We continue to believe that within biotechnology, M&A activity may continue to increase as larger biotech companies seek to fill pipeline gaps and product in-licensing could outnumber outright acquisitions. We should also see continued strong cash generation, with share repurchases serving as a significant backdrop for most companies in 2008.

The strategy continues to be overweight the Financials sector; however, we have positioned ourselves exclusively in capital markets and insurance companies with company specific growth opportunities. A steep yield curve, recapitalization of bank balance sheets and normalization of credit costs will create exceptional opportunities in the sector. However, in the near-term we remain cautious around consumer and commercial credit. Selectivity remains the best strategy in this environment. Aggressive action by the Fed and fiscal stimulus represent the first building blocks of a recovery in Financials, and we will continue to search out new opportunities as the environment improves.

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While the Industrials sector constitutes a wide ranging group of unrelated industries that offer a variety of investment options, this sector is most susceptible to the slowing economy. We have identified several areas that we believe should be able to grow despite this potential slowdown. Aerospace and defense comprise the largest concentration of holdings, but additional positions are held across machinery, construction and engineering, and electrical equipment. The portfolio is underweight Industrials due to a contracting US manufacturing economy and there are signs that global growth is slowing on the margin. We will continue to search for secular growth companies and be opportunistic around a cyclical recovery in GDP.

While maintaining a generally cautious approach to the Consumer Discretionary sector, we have recently increased exposure here. Specialty retailing has presented a number of opportunities and we are now slightly overweight the segment based on improving earnings and historically low valuations. Some of our larger exposures are within the leisure equipment and products, and apparel/luxury goods segments. While rising energy costs, more broad based inflation, and declining home values are obstacles for the consumer in this environment, we have found selective opportunities that have been able to grow earnings despite the broader slowdown. These opportunities can further benefit when the overall sector begins to recover and potentially offer leadership among their groups.

Our exposure in the Energy sector is concentrated in equipment and services, but we do carry an exposure to oil and gas production as well. We continue to experience robust demand for oilfield services worldwide. High energy prices appear less short-term in nature and more like a sustainable trend. As evidence supporting a long business cycle accumulates, these companies usually begin to consider how to position themselves more aggressively. Increasingly, they want to take advantage of the near-term window of opportunity to make strategic investments and acquisitions.