

US Mid Cap Opportunistic Value 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 stress 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 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, selected markets including auction rate notes to “freeze” and contributed to a modern day version of a “run on the bank” at Bear Stearns. The restrictive credit environment, higher energy costs and declining home values dampened consumer spending during the period. Consumer spending accounts for two-thirds of GDP growth and its slowdown could have serious negative implications for corporate profits and overall economic activity in the months ahead. Commodity prices continued to soar, with agricultural 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. The small cap oriented Russell 2000 Index fell 9.9%, the Russell Mid Cap Index dropped 10.0% and the Russell 1000 declined 9.5%, creating one of the most difficult performance quarters 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 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 1000 Index produced negative returns. On the positive side, both the Federal Reserve and Congress 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 an additional 200 basis points and has implied its 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 these 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 Mid Cap Opportunistic Value Equity Strategy outperformed the Russell Mid Cap Index during the quarter (based on net-of-fees performance). However, the outperformance was partially a function of the portfolio declining less than the index. Strong stock selection in many sectors also assisted the outperformance. We are also pleased to report our investment process change targeting the reduction of downside portfolio volatility continued to benefit returns during the period of market weakness.

Sector Review

The Energy sector was one of the strongest contributors to the quarter's outperformance. Our concentration on companies exploring for natural gas produced excellent returns as the price of natural gas recovered and the cold winter increased overall demand. Our process excelled in this environment as our focus on companies with large earning potential due to large reserve bases was rewarded by the market.

The surprise and hostile take-over bid at a 40% premium over recent trading prices for our holding in the video game area produced the

(Continued on next page)

US Mid Cap Opportunistic Value Equity Management

First Quarter 2008 Investment Commentary

largest contributor to the Technology sector returns. A moderate underweight and emphasis on more protected business franchises in IT services and semiconductor segments proved to be timely.

The Healthcare sector was another strong contributor to the quarter's outperformance. Our focus on healthcare equipment and supply companies was notable for its positive absolute performance in a difficult market environment. For fundamental and valuation reasons we did not have any exposure to HMO's which proved to be beneficial when rising medical loss ratios were announced by some of the largest companies in the sector.

Utilities and Materials, both areas which historically have been positive contributors to performance, were detractors in the period. After a strong finish to the end of 2007, some of our holdings in the utility area experienced profit taking in the early part of 2008. Limited exposure in the life science tools & services detracted from relative performance.

Looking Forward

As we move forward through 2008, we anticipate continued high volatility. We expect the market will be challenged by many of the current issues and could experience new negative developments that may include diminished corporate profits, rising unemployment and higher inflationary pressures. However, there are also positive events that could help stabilize the market and place it into recovery mode. At some point, investors could begin to focus on the benefits of the large Fiscal and Monetary stimulus that has been placed into the US economy. The eventual recovery in corporate profits could act to stabilize and enhance stock market returns. Improvement in investor sentiment should trigger favorable revaluation. Overall, we feel that our investment process is well suited to outperform in this volatile market period.

With the significant price weakness experienced in the area, we have been finding many new investment opportunities in the Consumer Discretionary sector. Multi-line and specialty retailing areas have presented a number of opportunities and we are overweight the sector based on projected recovery earnings prospects and historically low valuations. We used recent market rallies to reduce our exposure to the home building and restaurant industries.

Healthcare remains a fertile area of investment opportunity for the portfolio. Both the healthcare equipment & supplies and the specialty pharmaceutical areas present several attractive investment options. Our discipline in the sector calls for emphasis on companies marketing approved products that are not yet appreciated or understood by the consensus view. We are also valuation sensitive and will not chase the richly valued "hot stocks" that periodically appear in the sector.

Consumer Staples offers some of the best positioned industries to cope with rising inflationary pressures. Historically, supermarket

companies have been able to pass along rising food costs to consumers and maintain margins in the process. Higher retail prices generate a higher profit per unit, thus maintaining or enhancing company profitability. Cosmetic companies are in a similar position and also somewhat immune to general economic trends. We are also finding interesting investment ideas in food products and beverage industries.

We continue to underweight the Financials sector and are maintaining a cautious stance to many areas in the sector. As mentioned in the past, we are concerned about the impact deteriorating credit quality and increased loan-loss provisioning would have on the income statements and balance sheets of the traditional banks. However, with the decline in the Fed Funds rate, funding costs have begun to improve and the yield curve has become more favorable. We are maintaining a significant underweight to the area, but are encouraged to see the first building block to a fundamental recovery being put into place. We are also significantly underweight REITs but watching the sector for exceptional valuation opportunities to present themselves. Specialized small and mid cap insurance companies constitute the largest overweight in the Financials sector.

Our exposure in the Energy sector is concentrated in exploration companies and small refiners. Natural gas prices have yet to catch up with \$100+ barrel pricing for crude oil. Small and mid sized capitalization exploration companies offer more exposure to the benefits of rising natural gas prices, the ability to grow production more quickly than the larger integrated energy companies and the potential to be acquired by a larger competitor. At the same time, their smaller size can make their stocks more risky in periods of declining oil and gas prices.

Information Technology is the largest absolute exposure in the portfolio, but we are modestly underweight relative to the benchmark. Our exposure is broadly diversified, across many segments with some of our larger exposure in the semiconductor, IT services and software areas. Our emphasis is placed in stocks that have experienced significant price weakness, expectations are very low and a positive revaluation catalyst has been identified within the company.

Although the investment environment ahead could be challenging, we view the potential volatility as an opportunity for our investment process to continue to generate outperformance driven primarily by stock selection. Our commitment to independent thinking and intrinsic valuation should allow us to identify stocks significantly undervalued in the market place. Our fundamental research will determine the presence of a catalyst and provide conviction in the investment thesis. Application of our target prices should enable a disciplined exit strategy and profit realization for positions that have appreciated. In all, we are highly confident in our team, investment process and portfolio management capabilities.