

US Small Cap Blend 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.” These 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 Small Cap Blend Equity strategy performed in-line with its benchmark, the Russell 2000 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. Despite this, the portfolio remained competitive relative to its benchmark.

Sector Review

The portfolio was positively impacted during the quarter by its relative exposure to the Consumer Discretionary and Energy sectors. Our Consumer Discretionary exposure benefited from stronger relative investments in the restaurant, consumer services, and household durables segments. Despite concerns of wheat prices and food inflation, our investment in an operator and franchisor of a retail bakery café business rose sharply as

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management outlined a three-phase price increase and a menu focused on higher margin items. Within consumer services, our investment in a provider of workplace services for employers and families rose on an acquisition offer from a private equity firm. Within the durables segment, our investment in a regional homebuilder rose as homebuilders begin to come off troughs, and this company is well positioned as it continues to wait on the sidelines to re-enter the land market, with \$2.5 billion in liquidity and zero net debt, giving it a position of strength.

Energy remained a focus of the portfolio and strong stock selection coupled with an overweight led to strong relative performance. Within oil and gas exploration, an investment in a natural gas and crude oil producer, focused in various onshore United States regions, was up as the company continues its impressive track record of reserve and production growth. One of our oil and gas producers posted higher fourth-quarter profit, boosted by results that reflect continued strong production growth from the company's successful drilling activities. Within the equipment and services segment, an oilfield services provider saw its fourth-quarter net income rise due to stronger than expected revenue, boosted by the strength of its drilling business. Another diversified services company serving the drilling, pipeline, and exploration markets, rose despite lower earnings as higher costs during the quarter impacted the bottom line. However, as business demand remains robust, it seems investors believe the company will be able to sustain earnings growth in this environment. We continue to be positioned in those companies we believe can sustain earnings growth within this sector, as the supply-demand relationship remains tight.

Conversely, the portfolio was most negatively impacted by investments in the Financials and Information Technology sectors. While the Financials sector has been under pressure for quite some time, our positioning has been well rewarded. So far this year we have been hurt on a relative basis due to our underweight exposure within REITs, despite outperforming the benchmark. REITs, which is by far the biggest benchmark segment within Financials at just over 6%, has been down marginally thus far for the benchmark and an anchor against declines in other financial segments. We remain concerned about REITs and continue to evaluate opportunities within the segment, but have thus far few specialized REITs that are attractive, especially in this environment. The next biggest benchmark segment, commercial banks, has been an area we continue to underweight and have slightly underperformed the benchmark in. Our investment in a niche banking and mortgage company that has always had an efficient operating strategy, consistently reporting strong efficiency ratios and strong loan growth, fell as the credit environment has deteriorated.

Within Information Technology, electronic equipment, IT Services, and communications equipment pressured returns the most as investor concerns of broader technology spending remain a concern. An investment in a manufacturer of embedded computers, using

components for high-performance digital signal and image processing systems primarily used in defense and medical applications, fell on weaker earnings and a negative outlook. One of our holdings in the IT Services space, a global information services company, fell as third quarter profit declined; however, the company maintained fourth quarter estimates and lifted its 2008 outlook.

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 overweight 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 in on a number of companies in the sector that we believe have solid prospects for strong earnings growth. Our larger exposures remain within the IT Services, software, and semiconductors segments.

The Healthcare sector remains a fertile area of investment opportunity for the portfolio, and as such, 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. However, with the 2008 Presidential Election looming, investors will be very sensitive to the change in administration, and healthcare investing will likely be a challenge, given the importance of government policy to overall spending for healthcare products and services.

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We continue to underweight the Financials sector as we believe that continued pressure and a destabilized environment remains a concern. Despite the near collapse of Bear Stearns and ensuing investor diligence on counter-party risk and transactions, we believe that the segment offers a strong case for capitalizing on the volatility in global markets. We remain concerned about banking overall. Balance sheet growth is slowing, deposit pricing remains competitive, and relative and absolute valuations remain stretched despite weakening fundamentals and lowered earnings expectations. The broader implication continues to focus on the impairment of capital and a substantial impact on the economy as credit availability remains tight. Selectivity remains the best strategy in this environment, especially until clarity emerges on the credit front. 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 encouraged to see the first building block to a fundamental recovery being put into place.

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 we believe should be able to grow despite a potential slowdown. While we have spread exposure here across several segments, machinery, commercial services and supplies, and aerospace and defense comprise the larger concentrations. We view many of our companies as well positioned for the eventual recovery in US economic growth. As we indicated last quarter, many end-markets are currently healthy. The agricultural sector is experiencing rapid growth because of a worldwide boom in bio-fuels and a growing world population demanding higher-protein diets. The added demand for grains and oilseeds has dramatically increased the prices of agriculture commodities such as corn, soybeans, wheat, and palm oil (which all hit new highs for prices during the first quarter). With higher prices and greater demand for agriculture production, farmers and their suppliers around the world continue to experience the "perfect storm" that is giving them pricing power for the first time in decades.

While maintaining a generally cautious approach to the Consumer Discretionary sector, we have not altered our overweight exposure here. We continue to be well diversified within the sector, and have investments across a number of opportunities based on improving earnings and historically low valuations. We have exposure to the specialty retail, media, restaurant/leisure, and apparel/luxury goods segments, among several others. 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 diversified between equipment and suppliers as well as oil and gas companies. 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.