

US Small Cap Opportunistic Value Equity Management First Quarter 2008 Investment Commentary



Investment Environment

The first quarter of 2008 witnessed an acceleration of the economic 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 first 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 5 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 Small Cap Opportunistic Value Equity strategy modestly outperformed the Russell 2000 Index during the quarter (based on net-of-fees performance). However, the outperformance was a function of the portfolio declining less than the Index. Stock selection was the principal driver of 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 Healthcare sector was the strongest contributor to the quarter's outperformance. Our focus on companies ramping up new product offerings was rewarded in the specialty pharmaceutical, hospital supply and medical technologies areas. For fundamental and valuation reasons we did not have any exposure to biotechnology, which proved to be beneficial when investors sought the safety of more established companies.

Positions in the Consumer Staples area exhibited less downward volatility and our overweight drove the positive contribution to results. Emphasis on the cosmetic, grocery store and network marketing segments were the strongest contributions, as earnings results were actually better than expected in many

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instances. Exposure in the food products area modestly detracted from performance, but we believe cost and pricing trends will turn more favorable in the months ahead.

Stock selection in the Energy sector was strong. 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 largest contributor to the Technology sector returns. A moderate underweight and emphasis on more protected business franchises in the IT services area proved to be timely.

Our holdings in commercial services, freight logistics and the trucking industry generated a modest contribution to performance from the Industrials sector. The sharp increase in jet fuel costs hurt the profitability of our only position in the airline industry.

In a reversal from last year, the Financials sector was the largest drag on performance in the quarter. Many stocks that experienced significant declines in 2007 experienced smaller declines in the March quarter as selling pressure shifted to other segments of the market. By declining less than the overall benchmark, financials became an "attractive" area from a relative performance standpoint and our large underweight hindered performance. Our exposure to a high quality REIT and a leading pawn shop operator were also detractors to 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.

Information Technology is the largest absolute exposure in the portfolio, but we are underweight relative to the benchmark. Our exposure is broadly diversified, across many segments with some of our larger exposure in the internet software & services, IT services and computer peripherals areas. Our emphasis is placed on companies that have low technological obsolescence risk, a strong product or servicing position and are priced attractively.

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 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.

Industrials constitute a wide ranging group of unrelated industries that offer a variety of investment options. Commercial services comprise the largest concentration of holdings, but additional positions are held in airline, electrical equipment, freight logistics, and trucking companies. We believe our companies are well positioned for the eventual recovery in US economic growth.

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 the network marketing industry.

We are maintaining a generally cautious approach to the Consumer Discretionary sector. Rising energy costs, more broad-based inflation and declining home prices inhibit the purchase of large non-essential consumer items. We used recent market rallies to reduce our exposure to the home-building and restaurant industries. Specialty retailing has presented a number of opportunities and we are overweight the sector based on projected recovery earnings prospects and historically low valuations.

We continue to underweight the Financials sector and are maintaining a "wait and see" approach 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 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. Smaller 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

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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.

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.