

# US Small Cap 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, 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 the 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 Index declined 9.5%, producing 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 the 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 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 Small Cap Value Equity strategy was down in quarter and marginally underperformed its benchmark, the Russell 2000 Value Index (based on net-of-fees performance). Similar to the fourth quarter of 2007, the first quarter of 2008 saw significant price volatility as the economic landscape remains muddled.

### Sector Review

Our best performing sectors included Energy and, on a relative basis, Consumer Discretionary and Industrials. We continue to emphasize these sectors as we believe the fundamentals justify our target price forecasts. Our Energy investments remain focused primarily on energy equipment and services companies. With energy prices at record levels, we believe these companies will have steady revenue growth as exploration spending remains strong. Consumer Discretionary stocks and specialty retail, in particular, are currently very attractive. Valuation levels are at cyclical lows and the fundamentals for many of the companies are compelling in our opinion. Industrials holdings in commercial services and supplies performed relatively well and we have maintained our overweight as several opportunities appear compelling.

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Results were hampered by returns in Financials, Information Technology and Utilities. The Financials performed essentially in line with the index sector but the group did better than the overall Russell 2000 Value Index and our significant underweight detracted from performance. Several Technology stocks underperformed as earnings expectations were reduced and the stocks suffered. We are using the weaker stock market to upgrade the overall quality of our Technology holdings and reduce exposure to companies that may have more operating risk in a slower economy. We held a Utility investment that declined significantly after an unexpected very negative rate decision from the state utility commission. We subsequently sold the stock.

### Looking Forward

As we enter the second quarter, we remain focused on companies that can benefit despite the weaker economy, and are sensitive to valuation and fundamentals that belie a company's ability to achieve and sustain growth in this environment. While aware of the short-term momentum and headlines, we will focus on solid fundamental growth situations that are less sensitive to the potential slowdown in global growth.

Within Information Technology, we have reduced our emphasis but remain overweight the benchmark and maintain a fairly diversified exposure across the sector. We continue to believe that, as the economy moves toward higher capacity utilization, an emerging upgrade cycle will drive increased demand for technology related products and services. Many stocks within this sector are trading at compelling valuations and we have found a number of companies in the sector that have solid prospects for strong earnings growth.

We continue to be underweight the Financials sector and remain cautious about commercial banks as earnings are under pressure from reduced loan volume and deteriorating credit quality. Balance sheets are contracting and credit standards are being increased. The broader implication is a substantial impact on the economic activity as credit availability remains tight. Selectivity is the best strategy in this environment, especially until clarity emerges on the credit front.

Our Consumer Discretionary sector weight exceeds the benchmark weight as we continue to find pockets of opportunity in the face of softer consumer spending. The combination of higher energy and food prices, slowing job growth, and the ongoing nationwide weakening in home prices will continue to weigh on consumer spending. Our investment emphasis here is primarily specialty retail, media and household durables. We continue to remain selective and focus on companies with strong financials and dominant positions within their industries.

We increased our Energy investments and are now near a benchmark weight. The supply-demand relationship remains tight and pricing is firm. We have focused primarily on the energy equipment and services area as the more stable cash flows and longer-term view offer greater visibility into earnings. A shortage of skilled labor in the industry, as well as undervaluation, makes this group attractive. High energy prices appear less short-term in nature and more like a sustainable trend.

We reduced our overall exposure but remain overweight the benchmark within the Health Care sector. This sector should be less impacted by the slowing US economy and benefit from the broader themes that can continue to drive growth. Within managed care, earnings growth should remain relatively robust. However, with the 2008 Presidential Election looming, investors will be very sensitive to any changes produced by the November election, and healthcare investing will continue to be challenging.

Our Industrials exposure is now slightly over the benchmark weight. We continue to watch economic activity and the potential revenue impact of further softening demand. Capital expenditures will likely decline for a period due to credit market deterioration. Importantly, many end-markets remain healthy.

Our process is one of bottom-up stock selection based on valuation and fundamentals. Sector overweights and underweights result from these decisions and are reflective of our thoughts on the stocks more so than on our economic outlook. We continue to take a long-term view and look for market overreactions to short term issues to provide us with investment opportunities.