

# Emerging Markets Value Equity Management

## Fourth Quarter 2009 Investment Commentary

### Investment Environment

After shaking off the Dubai World debt restructuring, Emerging Markets finished 2009 with a respectable fourth quarter return. Unprecedented fiscal and monetary stimulus around the world averted an extended economic crisis and encouraged investment in higher beta assets. Emerging markets were key beneficiaries of capital allocation, a declining US dollar's impact on commodity prices, and healthier balance sheets. Investors continued to buy hard assets, pushing commodities higher, but performance was broadly robust with Financials and Consumer stocks delivering high returns. Mexico ranked highly on the back of acquisition activity in the Consumer Staples sector and the improving US economy. High energy prices and a shift in the Eastern European outlook supported Russian equities, and Chinese Consumer stocks took the lead, driven by auto manufacturers and consumer conglomerates.

### Portfolio Performance Review

The Emerging Markets Value Equity strategy underperformed its benchmark, the MSCI Emerging Markets Index, during the fourth quarter of 2009 (based on net-of-fees performance). As the Emerging Market rally extended into the fourth quarter, it became more challenging to deliver above-index returns. Prudent positioning in Asian financials, with an emphasis on undervalued South Korea versus China, detracted from alpha during the period. The portfolio's limited exposure to the steel sector and a price war among Indian telecoms provided headwinds as well. Stock selection was solid in Latin America and in the Consumer Discretionary sector.

### Country Review

#### Overview

China proved to be the most challenging market during the last quarter, as the Financials sector was up sharply and defensive utilities companies were down. Even with an underweight in Brazil's sizeable commodity sector, the country ranked as the portfolio's top-performing market during the quarter, led by a healthcare company and a specialty chemical producer.

### Asia

**China** – China sailed through the “Great Recession,” never having reported a contraction in economic growth. The government's speedy execution of public projects helped rural migrant unemployment to recover quickly by the middle of the year. Banks and auto-related companies were top performers in the quarter.

**Taiwan** – The technology cycle remains in full swing, as Taiwanese foundry companies and contract manufacturers deliver positive earnings and relatively upbeat outlooks for 2010. Taiwan was by far the portfolio's top-performing market this year.

### Latin America

**Brazil** – Brazil remains the Latin America favorite, following a swift economic recovery. Although the commodity producers performed well this quarter, consumer-related stocks took the lead. The flourishing middle class and nascent credit culture should support local demand. The portfolio outperformed the Index, with an insurance company and footwear producer among the top stocks.

### EMEA

**Russia** – The outlook for Russia has picked up with stable to solid oil prices. Many analysts expect oil to hover around \$85/bbl next year, a key positive for this commodity-dependant market. The portfolio does not own Russia's largest state-owned bank, a major index constituent, which caused a slight performance shortfall.

### Country Allocation Review

Country allocation was marginally negative due to a lower weight in Mexico, which was offset by solid stock selection. A more favorable outlook for the US economy, better-than-expected remittances from immigrant workers, and M&A activity in the consumer space bolstered the market. Higher weights in South Korea and Thailand also detracted from country allocation.

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THE BOSTON COMPANY

ASSET MANAGEMENT, LLC

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### Sector Review

**Consumer Discretionary** – Consumer Discretionary stocks surged during the quarter on the back of robust auto sales and generally healthy demand in most countries. The portfolio benefited from exposure to Chinese auto makers, South Korean retail, and a wide range of positions including names in Turkey and Brazil.

**Healthcare** – The growing emerging middle class and more discerning customers in developed countries provides dual catalysts for healthcare companies. Generic drug companies should do well as the US looks to reduce healthcare costs. In addition, hospital operators and health insurance providers are well-positioned for the rise in Emerging Market disposable income. The portfolio's healthcare companies finished well ahead of the Index, led by a Brazilian insurance company.

**Materials** – The Materials sector posted a modest return with Brazilian steel stocks ranking among the top performers. The outlook for Brazil's local economy continues to improve, and although the steel producers have exposure to North America, expectations for stimulus-induced infrastructure projects are providing the industry with further support. The portfolio underperformed in Materials due to its lack of Brazilian Materials exposure and heavier South African exposure.

**Telecommunication Services** – The Telecom Services sector underperformed the Index during the month as a price war broke out in India between leading mobile operators. In addition, Chinese and South Korean telecom operators lagged in the period. The Index outperformed the portfolio due to our mix of names in the aforementioned markets, many of which have since stabilized.

### Sector Allocation Review

Sector allocation was slightly negative during the month, primarily driven by an underweight to Materials and higher Telecom Services exposure, with the latter hurt by cyclical momentum and a price war in India.

### Looking Forward

Emerging Markets appear to be at an inflection point, as economic power has clearly shifted in their favor from the developed world. The worst drop in industrial production since the Great Depression hit manufacturing centers in emerging countries particularly hard, yet most adeptly weathered the storm. In hindsight, the business reaction was clearly extreme, as was the investment reaction. We remain confident that a secular shift has taken hold and will continue to support higher top-line growth, better margins and solid earnings growth, despite the periodic bumps along the way. In addition, Emerging Markets will become an increasingly larger piece of the global market cap, yet remained under-owned by many investors.

Much of this trend is reflected in the exponentially solid recovery last year. Emerging Markets are no longer deeply undervalued, nor are they overvalued. Earnings expectations have improved – consensus now expects 30% EPS growth in 2010 – making aggregate upgrades harder to come by. And there are near-term headwinds that could impede a sustainable rally, namely commodity driven-inflation, policy missteps as government stimulus winds down, excess capacity or potential asset bubbles, and protectionism to either control fund flows or shield domestic businesses. This creates a more selective environment, with a higher level of performance dispersion between markets. Thematic trading should ebb and business fundamentals will likely have a more measurable impact on added value. Finding quality companies that have been overlooked in favor of the effortless cyclical trade could prove challenging, but we are particularly familiar with this approach. It has been consistently applied to Emerging Markets investing since the strategy's inception.

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