

# US Large Cap Growth Equity Management

## Fourth Quarter 2009 Investment Commentary

### Investment Environment

The US stock market closed out its best year since 2003, representing a dramatic turnaround from the negative performance of 2008 when the global economic crisis resulted in the market's worst year since the Great Depression.

During the fourth quarter, global equity markets advanced as investors were encouraged by positive data pointing to economic recovery in 2010. Initial weekly jobless claims declined from elevated levels during the quarter, an encouraging sign that the employment picture was beginning to stabilize in the US. At the same time, the manufacturing sector rebounded moderately and business confidence rose. In the United States, third-quarter gross domestic product (GDP) was positive for the first time in five quarters (revised from 3.5 to 2.8, but positive nonetheless), giving investors another milestone marking the end of the current recession.

Markets briefly pulled back during the period on news of Dubai World's decision to suspend their debt repayments, causing risk aversion to take hold in the broader markets as sovereign debt risk more generally came back into focus toward the end of November. While the Q309 earnings season began with a string of positive reports in the US, later in October saw more mixed results, particularly among European, UK and US commercial and investment banks. Third quarter corporate earnings results were ultimately disappointing, with most of the gains coming from cost cutting while very few companies reported an acceleration of their top-line revenue growth.

Emerging Asia demonstrated exceptional resiliency and has led the overall global recovery as China, India and Indonesia managed to avoid recession. China's manufacturing growth held at its fastest pace in 18 months; India's economy grew 7.9%, its fastest expansion in 1½ years; and South Korea's exports rose 19%, the first gain in 13 months. Japan struggled, as currency headwinds could seriously undermine the country's sizeable export sector. The Organization for Economic Cooperation and Development predicted that next year the US economy would expand 2.5%, the eurozone would grow 0.9%, and Japan would advance 1.9%.

### Portfolio Performance Review

The US Large Cap Growth Equity strategy underperformed its benchmark, the Russell 1000 Growth Index, during the fourth quarter of 2009 (based on net-of-fees performance). Driving the portfolio on a relative basis were the Materials and Energy sectors. Conversely, the Healthcare, Consumer Discretionary, Information Technology, and Consumer Staples sectors negatively impacted the portfolio. We continue to keep the portfolio well diversified, especially as economic activity picks up across sectors at various levels.

### Sector Review

**Materials** – The portfolio experienced solid relative performance driven by the chemicals and metals & mining segments. Our exposure to a specialty chemical company drove that segment, as the company's outlook was solid with new opportunities in advanced engineered materials.

**Energy** – The portfolio benefited most from relative exposure to the exploration & production segment.

**Healthcare** – The sector was negatively impacted by the portfolio's relative exposure to the pharmaceutical, life sciences tools & services, and equipment & supplies segments.

**Consumer Discretionary** – Within Consumer Discretionary, the media, household durables, and leisure segments were the biggest relative detractors. A household durables company and a leisure company were both down for the year.

### Key Sector Strategies

**Materials** – The economic environment for the Materials sector appears to be positive. With global stimulus measures largely in place, demand for materials should rise as infrastructure projects are largely targeted. Additionally, if the weak dollar persists, it should benefit the internationally-exposed Materials sector. The global growth story, anchored by China, is further support for this sector. Although concerns persist that China may be looking to tighten the reins on its spending, it is highly unlikely given their commitment to aggressively attacking their economic issues by further infrastructure improvements.

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THE BOSTON COMPANY

ASSET MANAGEMENT, LLC

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**Energy** – Technological advances in the oil services industry has made it economical to extract oil and natural gas from shale formations. This advancement has created exciting growth opportunities for companies in the exploration & production and oil services industries.

As signs emerge that the global economy is stabilizing, energy will be a critical component of infrastructure improvements, which remain targeted by governments seeking to boost their economies. Longer-term, we continue our positive stance on the sector. Developing countries should continue to demand more fuel as they grow. Once the global economy starts to recover, we believe that trend will shore up demand again.

**Healthcare** – Looking back at 2009, healthcare stocks underperformed the market as investors grappled with uncertainty driven by the constantly changing direction of the Washington reform discussion. This was magnified by investors rotating into more economically sensitive sectors to position portfolios for a recovery from the recession. As we begin 2010, we continue to be selective with our investments and sector position. The healthcare debate in Congress remains the biggest cloud overhanging the sector, causing both investor and company paralysis as the details of a "Reform" bill are being finalized. On a positive note, it appears that a worst-case scenario for the industry has been avoided (a large government run public plan) and cost controls may be moderate if the final version of the combined bill looks like the narrowly approved Senate version. If a bill eventually passes, the legislation should significantly expand the insured population in the US and create opportunities for certain sectors within the healthcare industry. In addition, we think the sector could experience a relief rally if a bill passes and the operating landscape becomes clearer.

While it is still too early to draw concrete conclusions from the ongoing debate, we believe that some healthcare service providers such as hospitals and select insurance companies could benefit from a greater number of insured patients. In addition, health care information technology companies should benefit as the government incentivizes hospitals and physician offices to transition to electronic health records through stimulus funding and/or penalties. Although pharmaceutical and medical technology companies could benefit from increase higher patient volumes, potential top-down cost controls, pricing restraints, reimbursement cuts and higher industry taxes could impact industry profitability and offset some of these positive factors. Fundamentally, many companies have solid growth prospects, cash flows and secure balance sheets—all attractive factors to investors. After the Congressional debate subsides, potential industry consolidation could lead to multiple expansion and increased attention. We continue to weigh these positive attributes against increased government regulation leading to our selective sector positioning.

**Consumer Discretionary** – We expect a tepid increase in consumer spending in 2010. Personal income should grow with the economy, but inflation in essential spending (energy, food, healthcare) and de-leveraging (rising savings rate) will be offsetting factors. While the holiday shopping season data trickles in over the next few weeks, results seem to be flat to marginally positive. Consumers appear to remain hesitant about spending. At the same time, consumers have been reluctant for some time, so pent-up demand could lead to pockets of upside surprise across the sector. Additionally, retailers have been cautious and aggressively managing inventory levels, which could help limit the level of discounting we have seen, which has weakened their bottom lines in the past. This could provide margin support for a number of consumer companies. While aggressive consumer spending is likely a thing of the past for now, consumers should continue to reduce their debt burden and bolster savings, ultimately strengthening their balance sheets.

### Looking Forward

Investors should view 2009 as an overall good year for the markets, helping many to recover some of the painful losses from the previous year. More importantly, many of the government stabilization plans seemed to work, and the global economies have responded with some slow, but positive signals. Most of the biggest US banking institutions have returned their TARP money, and are moving to focus on their businesses and the future of financial services. As the financial system stabilizes and moves towards growth, we should see the economy pick up further. Both the US and international equity markets posted solid gains, with the S&P 500 Index advancing just over 26% and the MSCI EAFE Index up almost 32% for the year. Lower-quality stocks performed very well for the year, as these companies led the early stages of the rally and gained momentum throughout the year.

However, investors were busy toward the close of 2009 with an abundance of issues that remain x-factors entering 2010, such as healthcare reform legislation, unemployment data, rising gold prices, trouble for sovereign borrowers (such as Dubai), extension of government programs (such as removing the assistance caps for Freddie Mac and Fannie Mae), and low interest rates (with the Fed's indication that rates will remain low for the foreseeable future). One of the key factors will be to monitor key governmental policy decisions on interest rates and spending. It is likely that the government will remain accommodative throughout the year to allow for the economic recovery to gain some momentum. Unemployment is likely to continue to be a drag on economic growth, as companies remain cautious regarding hiring decisions and adding additional costs to payroll.

As we move forward, the strength of the economic rebound will have implications for what stocks drive leadership from this point forward. While the low-cap, low-quality stocks drove returns in 2009, investor focus on earnings, balance sheet strength, cash flows, etc. should emphasize a focus on more quality-oriented companies. Given

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the strength of the market rally in 2009 and the skepticism over a sustained recovery, markets will probably scrutinize economic data closely. Investors will likely be more cautious of risk, knowing that markets and sentiment can shift as the dynamic changes. Markets are still sharply below the last highs, so long-term investors could use market fluctuations as an attractive entry point for what will likely be a slow and shifting recovery. This would help the markets as the significant assets that have been on the sidelines during the relief rally of 2009 could finally be put to work.

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