

US Mid Cap Opportunistic Value 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 Mid Cap Opportunistic Value Equity strategy outperformed its benchmark, the Russell Midcap Index, during the fourth quarter of 2009 (based on net-of-fees performance). Holdings in the Energy sector benefited most to relative returns. Stock selection in natural gas exploration companies and the timely purchase of coal stocks were most beneficial. Nimble purchases of a beneficiary of infrastructure spending and a manufacturer of truck engines drove performance in our Industrials exposure. In Financials, our positions in insurance, real estate management, capital markets and thrifts outperformed their benchmark peers. Our holdings in Technology rested while the benchmark's stocks rallied, creating the weakest area of relative performance in the period.

Even though the market began the year with a severe decline and then rallied sharply during the balance of the year, the portfolio outperformed the benchmark during all four quarters of 2009 on a gross-of-fees basis. Stock selection provided over 70% of the excess returns generated for the year. The team's dedicated research staff delivered positive alpha in 2009: nine out of ten sectors outperformed the benchmark.

Solid drivers to 2009 performance

Financials – The Financials sector contributed most to one-year returns. Investment tactics applied in the sector were quite solid. Having maintained the large underweighting of commercial banks, credit card companies and REITs, the portfolio was protected from the final, sharp meltdown of the sectors in the first quarter. It also left the portfolio free to buy selective names at excellent valuation points throughout the year. As a result, we were able to make some outstanding investments in the credit card and real estate management industries.

Consumer Discretionary – Our concentration in established brands with healthy balance sheets worked well in specialty retailing. Valuation discipline steered a shift out of auto parts retailers and into automotive components. We locked down gains from an old investment theme and started a new one at very attractive prices.

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Industrials – Contrarian views on many stocks in this sector produced timely buys in the construction & engineering, machinery and building products segments.

Materials – Positions in this sector delivered the portfolio's largest gains with increases greater than 100% in two of our five holdings.

Energy, Technology, Utilities and Healthcare – Each sector contributed more than 100 basis points to relative performance. In fact, Telecommunication Services was the only sector showing underperformance for the year, but its effect was very minor.

Sector Review

Financials – Investment strategies within the Financials sector worked well during 2009. At the beginning of the year, positions in the diversified financial services, capital market banks and insurance areas performed positively. At the same time, our long-standing underweight of commercial banks and REITs protected the portfolio during the severe market decline that occurred in the March quarter. As the year progressed, profits were captured in the capital markets, consumer finance and diversified financial services segments and redeployed into the commercial bank, real estate management and thrift industries. For the year, the Financials sector gained over 60% versus a 17% gain for the benchmark peers.

Consumer Discretionary – Specialty retail, automotive components and household durables were the largest contributors to sector performance for the year. Several positions in the auto parts, auto components, consumer electronics, household furnishing, office supply and teen apparel contributed to absolute returns. As stocks reached Intrinsic Value, our disciplined selling process locked in the gains and reallocated the proceeds into more attractive reward-to-risk opportunities. Segments gaining incremental assets included auto and truck components, online education and media companies.

Telecommunication Services – Our position in a low-cost, point-to-point cellular telephone service provider suffered from a challenging pricing environment. However, the overall impact on the portfolio was minor.

Key Sector Strategies

Financials – Selectivity remains the operative word for our investment strategy in the Financials sector. We have been slowly building our exposure to commercial banks by concentrating on surviving banks likely to gain share as their competition fails. Additional positions are held in insurance, capital markets, REITs and real estate management companies.

Consumer Discretionary – The Consumer Discretionary sector remains the largest absolute weighting in the portfolio, but the emphasis has shifted with the changing opportunities within the sector. Auto and truck components, household durables and media areas have heightened exposure, while retail has been de-emphasized after the strong absolute price performance in 2009.

Telecommunication Services – After reviewing the fundamental thesis and valuation assumptions, we used the price weakness to add to our low-cost cellular service position.

Looking Forward

We believe the economy has now entered the recovery mode and that corporate profits will demonstrate meaningful year-over-year gains beginning in the fourth quarter and likely to last until the third quarter of 2010 or longer. The eventual increase in revenue, margins and profits should act as strong support system to allow the market to reflect higher level earnings and should increase investor confidence in domestic equities in general. We believe the market will continually present positive investment opportunities and we are confident our time-tested investment philosophy and disciplined stock selection process will continue to generate solid performance returns over the next market cycle.

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