

US Small 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 Small Cap Opportunistic Value Equity strategy performed in-line with its benchmark, the Russell 2000 Index, during the fourth quarter of 2009 (based on net-of-fees performance). Industrials led the fourth quarter results. Positions in the machinery, construction and engineering, and building products provided the lift. Our belief that meaningful Federal stimulus spending will occur in 2010 began to regain investor attention in the period. Telecom Services staged a nice year-end bounce and a new holding in low-cost cellular service immediately contributed. Energy, Materials and Utilities assisted modestly. Profit-taking in the retail, apparel, and hotel industries of the Consumer Discretionary sector detracted from performance.

For the one-year period, the portfolio showed excess return in both down and rally phases of the market in 2009. 75% of the outperformance came from stock selection. The team's dedicated research staff generated positive alpha in 2009: eight out of ten sectors outperformed the benchmark.

Solid drivers to 2009 performance

Consumer Discretionary – We bought retailers, restaurants and consumer durables as investors panicked about consumer spending. Timely purchases in automotive components on the belief that auto sales would recover after GM and Chrysler filed for bankruptcy were rewarded with triple digit gains in some holdings.

Financials – Our focus on surviving, thriving, and non-TARPed investment banks worked, while dodging many first quarter meltdowns in commercial banks and REITs protected the portfolio.

Industrials – Patience and then conviction were both rewarded as winter caution left buying power to shovel machinery, hazardous waste removal, and engineering and construction companies, where were added into the portfolio at attractive prices during the spring.

Technology – Select positions in semiconductors, software and peripherals were up more than 100% during the year.

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Consumer Staples – The only moderate drag to results occurred in Consumer Staples, where fundamental expectations in the pork production and grocery store industries did not develop as anticipated.

Sector Review

Consumer Discretionary – For the year, our positions in the Consumer Discretionary sector increased 120% in aggregate. Specialty retailing, automotive components and hotels, and restaurants & leisure were the most solid contributors to performance.

Financials – Investment tactics applied within the sector during 2009 were quite successful. Long held caution on commercial banks and REITs protected the portfolio during the March quarter financial meltdown. Focus on small cap investment banks that would gain market share from the Lehman bankruptcy proved to be quite profitable.

Consumer Staples – The fundamental expectations in the grocery store industry were not met. Same store sales did not increase as much as forecasted and margins did not benefit from reduced commodity and energy costs. The pricing environment in the pork production industry did not improve as rapidly as expected.

Utilities – The Utilities sector had a very minor negative impact on the portfolio returns for 2009. Our holdings increased slightly less than the benchmark peers, creating a minor drag on relative performance.

Key Sector Strategies

Consumer Discretionary – As the specialty retailing stock prices approached intrinsic value, gains were harvested and redeployed into the media and auto components industries. Overall the sector remains the largest weighting in the portfolio with broad diversification across the automotive components, household durable, hotel, leisure, media, retailing and textiles areas.

Financials – Selectivity remains the operative word for our investment strategy in the Financials sector. We are 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 Staples – Direct exposure to the grocery store and pork production industries was eliminated from the portfolio.

Utilities – Positions and weights in the sector are likely to remain relatively constant for the near term unless there are meaningful new developments in the industry.

Looking Forward

We believe the economy has now entered the recovery mode and 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 increase investor confidence in domestic equities in general. We believe the market will continually present positive investment opportunities and we are confident that 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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