

US Small Cap 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 Value Equity strategy outperformed its benchmark, the Russell 2000 Value Index, during the fourth quarter of 2009 (based on net-of-fees performance). Driving the portfolio on a relative basis were the Financials, Energy, Healthcare, and Industrials sectors. Conversely, the 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

Financials – The portfolio experienced solid relative performance driven by the REITs, thrifts, and commercial banks segments. While we remain underweight both the REITs and commercial banks segments, we believe we have been able to identify those companies with strong franchises and solid businesses that have been able to perform well.

Energy – The portfolio benefited most from relative exposure to the equipment & services area. One of the top contributors in the group benefited from an improving rig count and firming oil prices, as US drilling rig activity is up approximately one-third from June 2009 lows.

Information Technology – The sector was negatively impacted by the portfolio's exposure to the computers/peripherals and semiconductor segment. Although we outperformed in the semiconductor segment, our overweight in the weak benchmark group hurt relative performance. In the peripherals segment, weak demand remains a concern.

Consumer Staples – Within Consumer Staples, the food retailing segment was the biggest relative detractor. Some of the larger food retailers felt a slight pullback during the month.

Key Sector Strategies

Financials – Although we are underweight Financial stocks, we are gaining more confidence in banks, REITs and insurance companies, especially as the economy begins to strengthen. With an eye towards opportunities presented by sizable spreads in the yield curve and corporate balance sheet improvements, we see earnings growth in select

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markets that will likely outstrip current expectations. Bond market issuance has been very strong, indicative of substantial demand for credit, and bank loans should begin to grow during 2010 as well.

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, and once the global economy starts to recover, we believe that will shore up demand again.

Information Technology – The Technology sector remains a quality sector given the solid balance sheets, stable margins and rising estimate trends for many of the sector's companies. We believe these attributes offer a solid combination of growth potential and some modest defensive characteristics, which is especially attractive as the economy begins to regain footing. Demand is improving for both the corporate enterprise as well as the consumer, despite the pressures that the consumer continues to face. Technology was a leadership group in 2009, and likely to remain among the top-performing in 2010. As IT spending was somewhat depressed in 2009, we should see a marked improvement in 2010, providing a positive tailwind for the group. Product cycle improvements in areas such as cloud computing and server upgrades should also help the sector. We especially see strong momentum building in mobility, which will benefit both software and even more so, hardware segments. Among the beneficiaries driving demand will be smart phones and gateway appliances (the devices that connect to your home). Technology-company management teams have learned lessons from previous cycle inventory-builds and, for the most part, have maintained lean inventories. This should help maintain reasonable margins across much of the sector.

Consumer Staples – While typically defensive, the Consumer Staples sector still faces pressures from thrifty consumers that are increasingly cost-conscious. This can create pricing pressure on companies from the consumer and, subsequently, the retailer, leading to dampened profitability and slower earnings growth.

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 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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