

US Small Mid 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 Small Mid Cap Growth Equity strategy underperformed its benchmark, the Russell 2500 Growth Index, during the fourth quarter of 2009 (based on net-of-fees performance). The portfolio was positively impacted by holdings in the Healthcare and Energy sectors. Conversely, the portfolio was hurt on a relative basis by exposure to the Consumer Discretionary and Information Technology segments.

Sector Review

Healthcare – The portfolio saw relative strength driven by the biotechnology and life sciences tools & services segments.

Energy – The portfolio benefited from relative exposure to companies in the equipment & services and exploration & production areas.

Consumer Discretionary – The sector was negatively impacted by the portfolio's exposure to the specialty retail, textile/luxury goods and diversified consumer services primarily. A specialty retailer fell as quarterly earnings saw higher revenue but lower earnings as SG&A expenses pressured margins. Within the consumer services, our education company exposure was under pressure over concerns about additional regulation within the industry.

Information Technology – The Information Technology sector was primarily impacted by the semiconductors area during the quarter.

Key Sector Strategies

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

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cost controls may be moderate if the final version of the combined bill looks like the narrowly-approved Senate version. If a version of the bill 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 finally 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, healthcare 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 increased 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.

Energy – Technological advances in the oil services industry has made it economic 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.

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 deleveraging (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, 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 that has weakened their bottom-line 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.

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 are especially attractive as the economy begins to regain its 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 smartphones 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.

We were pleasantly surprised by holiday sales, as technology upgrades have been embraced and adopted by the consumer in 2009 and led to technology becoming a bigger part of their somewhat muted discretionary spending. As the consumer recovers, this could provide an additional positive for Technology.

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,

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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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