MARKET REVIEW | DOMESTIC EQUITY INTERNATIONAL EQUITY FIXED INCOME

First Quarter 2010

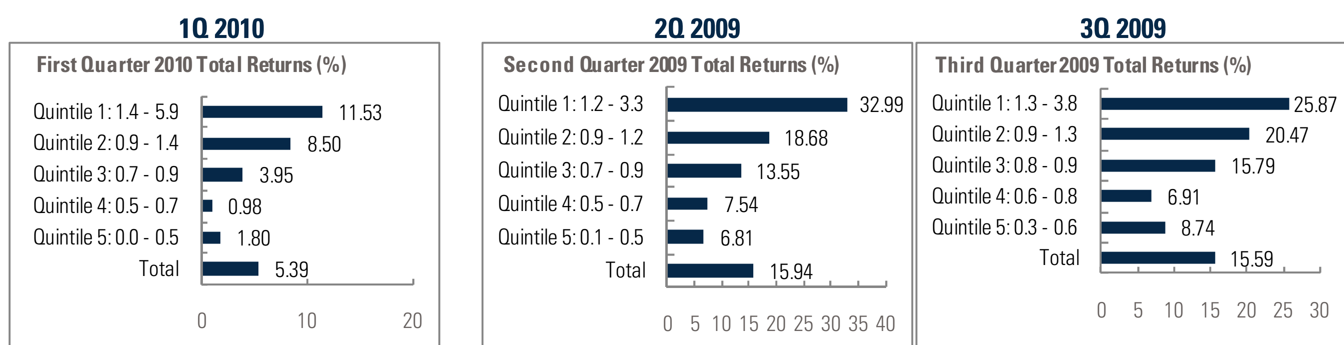
DOMESTIC EQUITY MARKET

The stock market, as represented by the S&P 500®, continued its recovery in the first quarter by posting a 5.39% return, which marks its fourth consecutive quarterly gain. Overall, that brings the return for the last 12 months to 49.77%. Other economic indicators support the contention that both the U.S. and world economies are well along their paths to recovery. It is likely that several countries, including the U.S., will hit new highs in nominal gross domestic product (GDP) in 2010. However, significant problems still remain as illustrated by the fiscal plights of Greece, Spain, Portugal, and Ireland. That said, it is very encouraging to investors that those markets continue to function and remain liquid.

Looking back to the U.S. market, investors are further encouraged by news from the domestic corporate sector as earnings have generally met or exceeded expectations. Improving sales trends indicate that not all the good news is being driven by cutting costs. The financial position of the corporate sector continues to strengthen, as does the optimism of CEOs, which is manifested in the significant resurgence in merger and acquisition activity during the quarter. Accumulating cash balances need to be reinvested and the market values of acquisition candidates have been enticing. This increase in M&A activity, coupled with the growth of new corporate bond issuance and the narrowing yield spreads, suggests the financial markets are stabilizing.

One of the most descriptive statistics to characterize a portfolio's performance in the first quarter of 2010 was beta, which is a gauge of a stock's volatility relative to the market. As the accompanying chart indicates, the stocks with the highest beta in the S&P 500® returned more than twice that of the benchmark as a whole, while the lowest quintile returned only approximately one-third of the benchmark. Investors aggressively pursued those stocks with the greatest volatility. A similar pattern of returns occurred in the second and third quarters of 2009. This trend suggests that investors appear to be discounting a continuing robust recovery in economic activity. However, quarterly GDP growth rates appear to have peaked at 5.6% in the fourth quarter of 2009, as most forecasters are looking for rates of increase between 2.5% and 4.5% in 2010. While continued economic growth would provide a constructive environment for equity prices, it may not be enough to sustain investors' interest in the market's most volatile stocks.

S&P® 500 Beta Quintiles



Source: Factset

As the economy and industries move through cycles, these changes impact equity volatility characteristics. For example, in the early stages of the market expansion following the dot-com decline (12.31.2003), the Barra predictive beta was 1.48 for the Russell 1000® Index information technology (IT) sector and 0.96 for the financials sector. This means that the IT sector was expected to be 48% more volatile than the market as a whole and the financials sector slightly less volatile. These are now reversed, underscoring how times have changed. As of February 28, 2010, financials have become the more volatile sector at 1.36, an increase of over 40%, and IT has dropped to 0.87, a decrease of the same magnitude. Given the longer term dynamics of the two sectors, it would seem reasonable to expect the volatility of these two sectors to once again move in opposite directions as the economy continues to recover.

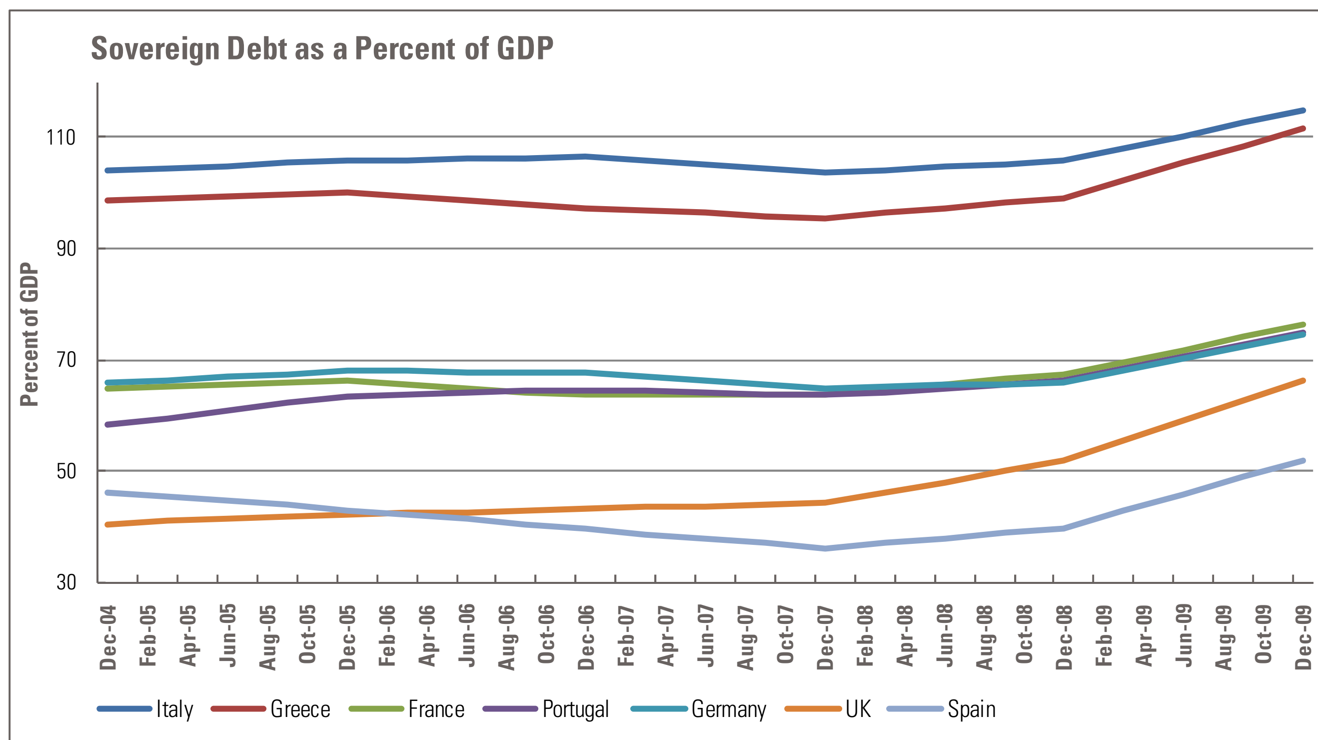
INTERNATIONAL EQUITY MARKET

International equity markets appeared calm during the quarter. However, while sector returns were fairly tight, individual country returns showed wide dispersion. The aftermath of the global market debacle is putting pressure on certain countries' fiscal conditions and, while this may vex bondholders, it can provide opportunities within those countries' equity markets from a security selection standpoint.

Maneuvering through the equity markets the last two years has been like running a marathon through a mine field. It was atypical at best, periodically requiring retracing of footsteps while keeping sights locked on the horizon where stability and normalcy lay. Looking back at the credit-induced crisis, many companies were saved and banks salvaged by governments betting on the future health of these organizations assuming a normal environment with GDP growth in the range of 2.5% to 3.5%. The consensus is still widely dispersed on whether global economies can grow at this pace going forward.

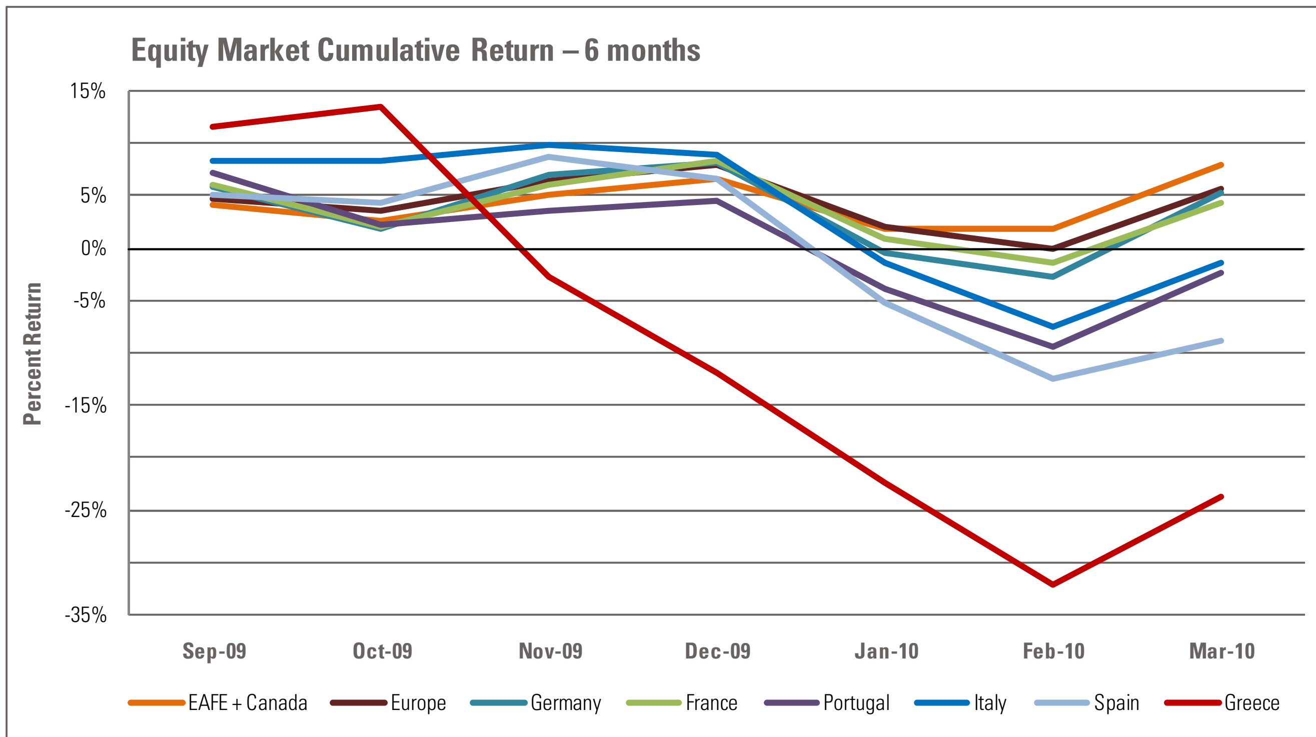
The net effect of the fiscal rescue thus far has been a significant shift in leverage from the private sector to the public sector. While lending and the ability to raise capital have improved, credit flare-ups are still apparent, globally, as deleveraging has not yet begun. It has only shifted to government balance sheets, which initially minimized losses, calmed markets and mildly stimulated economies. However, this debt still must be repaid in the future.

This is particularly the case in Europe as the wealthier, more developed countries such as Germany, France, and Netherlands have issued considerable government debt since 2007 to support their banking systems and economies. Other peripheral European Union countries such as Greece, Hungary, and Czech Republic continue to experience tremors from the credit crisis as their fiscal situations were deteriorating prior to 2008/2009 market events. Still other countries, such as Ireland and Iceland, are implementing drastic austerity measures to stabilize themselves financially. However, sovereign debt risk impacts all 27 individual nations that make up the European Union as the EU leadership would be pressured to be the lender of last resort for any of its members. An appeal to the International Monetary Fund would be detrimental to stability for the 16-nation currency because it would show that Europe was unable to keep its own house in order. The graph below depicts the debt creep relative to the size of local European economies. Italy and Greece are in troubling territory but even France and Germany are heading in a precarious direction.



Source: Datastream

It's not certain that a debt crisis can be solved by layering on more debt while extending the term or shifting it to government balance sheets in the form of "Quantitative Easing". This uncertainty is spilling over to specific equity markets in 2010. The MSCI EAFE Index (net dividends) produced a placid return of 0.9% in the first quarter, however, Euro region stocks were generally down 1.8% evidencing some turbulence. Within this broad index, Greece saw equity prices decline by 13.2% during the first quarter. Similarly, Spain, Portugal, and Italy followed as their local equity markets were down 7.0% to 15.0% for the quarter. The rating agencies have downgraded the sovereign debt of Portugal and Greece; other countries with swelling debt loads may follow. The graph below shows that the six-month cumulative returns of Greece, Italy, and Portugal lagged the rest of Europe in aggregate as well as the non-U.S. developed markets.



Source: MSCI

As the fiscal woes mount in Europe, an interesting anomaly has occurred: the perceived risk has risen for companies that are domiciled and listed on the exchanges of these leveraged countries. Guilt by association with a country experiencing deteriorating financial conditions may negatively impact the valuations of otherwise healthy companies. Many of these companies generate revenue from global sources. The U.K.'s fiscal position is, in some cases, just as precarious as Greece's with a forecast budget deficit for 2010 approaching -12% of GDP and growth lagging that of the European Union countries. However, nearly 70% of revenue generated from companies on the FTSE-100 Index is derived from outside Britain, much from the strong emerging markets. As an example, mining companies Rio Tinto PLC and Xstrata PLC list their stocks in London but their business is geared toward generating profits and earnings growth from China and India. During the first quarter, the U.K. market fell 0.6%, however, Xstrata was up 4.6% and Rio Tinto jumped 9.0%. In Spain, Banco Santander, which is listed on the Bolsa, saw its shares decline by 18.9% in the latest quarter in sympathy with the country's fiscal situation (Spain was down 15.3%). Yet the financial institution is in great shape and is acquiring banks and other operations in emerging market countries as well as in the U.K. The valuation is very attractive relative to the future earnings capabilities with a price-to-earnings of 9.1 times next year's earnings.* Another example in Spain is Telefonica, a large telecom services company, which has growth opportunities even as the telecom industry is in a consolidation phase. While growth in Europe is slow, they have been deriving new sources of revenue from expansion of telecom activities in Brazil. There are many companies that have positioned themselves well to benefit from accelerating growth in revenue from gaining new market share in Russia. We continue to find opportunities for earnings growth with attractive valuation characteristics in spite of the perilous condition of many peripheral European countries.

Investors following large macro themes would normally avoid stocks in some of these countries based on the inherent fiscal and economic risk. While we may underweight certain countries based on a lack of opportunities, our investment process allows us to identify potential winners in any region by focusing on companies with stronger business momentum and attractive valuations. We continue to be committed to managing international equity portfolios by seeking the best ideas for outperformance.

FIXED INCOME MARKET

The first quarter of 2010 looked much like 2009 from a performance perspective as investors became more comfortable with the prospects of an economic recovery and, as a result, continued to embrace riskier assets. While there were some bumps along the road, most notably the emergence of sovereign risk in Europe, spread product continued to handily outperform. Events surrounding the prospects of a default by Greece and the speculation that similar situations could exist in Portugal, Italy, Ireland, and Spain certainly gave investors pause, briefly interrupting the rally in the fixed income markets. Once it became clear that a combination of austerity programs and a joint solution from the European Union and the International Monetary Fund would likely avert a default, the bond market rally picked up where it left off.

Economic indicators continued to show a broadening of the economic recovery and the Federal Reserve (Fed) reiterated its intent to keep short-term interest rates low for an extended period. The combination of these two factors coupled with Corporate America's renewed access to the debt and equity markets pushed the values of riskier assets even higher. Much has been written about the troubles to come in the commercial real estate market, yet commercial mortgage-backed securities were the top performing sector within the investment grade fixed income markets, posting a return of 9.10% in the first quarter. Furthermore, high yield corporate bonds significantly outpaced returns posted by investment grade corporate bonds, 4.62% vs. 2.30% respectively. Conversely, Treasury securities had the lowest returns in the first quarter as interest rates were higher by quarter end resulting from larger auction sizes and lower levels of demand seen in these auctions late in the quarter. Additionally, both agency debentures and agency mortgage-backed securities underperformed corporate bonds and structured securities as investors favored these other spread sectors given the Fed's expiration of their quantitative easing program.

As we look forward, several important variables will impact performance in the fixed income markets, notably the outcome of the financial reform legislation, trajectory of the economic recovery, future changes in monetary or fiscal policy and, consequentially, investors' willingness to take on additional risk. While corporate balance sheets are strong and fundamentals are stabilizing (if not improving) in the financial sector, and fiscal and monetary policy remain supportive of growth, consumers continue to deleverage. Access to credit remains tight to many sectors of the economy. Both payroll growth and income growth are projected to remain soft in the near-term, which also does not bode well for consumer demand. As such, over the next quarter or two, export led demand and the inventory cycle are likely to be the drivers of continued GDP growth. In spite of this cautious environment, shareholder-friendly activities, such as dividend increases and share buybacks, are already returning to the markets, neither of which is beneficial to bondholders. As a result, investors will be required to remain mindful of these risks in the debt markets, but also embrace relative value opportunities that still exist in this post-crisis environment.

Given the current environment, we believe the following:

- **Maintain our overweight position in corporate bonds and structured product.** Our underweight position in Treasuries remained unchanged as we continue to view this sector as the most susceptible to underperformance given a recovering economy and increasing budget deficit, and hence, Treasury supply. Our focus remains on corporate bonds, most notably in the finance sector, as we feel a stronger economy will ultimately stabilize consumer and corporate credit allowing fundamentals in this sector to improve. Additionally, we are constructive on seasoned, super-senior commercial mortgage-backed securities which we believe still offer compelling yields relative to many other sectors.

- **Monitor closely the market's ability to adapt to a less accommodative Federal Reserve, higher taxes, and increased regulation.** As liquidity and other support facilities are allowed to expire and the end to quantitative easing is at hand, the fixed income markets must adjust not only to this new environment, but also to the likelihood of higher

interest rates. Our view for a slow economic recovery and muted near-term inflationary pressures leads us to believe the Fed will not be tightening monetary policy until late 2010 at the earliest. As investors attempt to predict the timing of these interest rate hikes, volatility in interest rates is likely to increase and could have a meaningful impact on performance over the next several quarters.

- **Maintain a defensive yield curve position.** We continue to believe the yield curve will remain steeper than historical averages given the likelihood for a patient Federal Reserve and the combination of increasing Treasury supply and the Treasury's desire to lengthen the duration of their portfolio. The yield differential between the 2-year and 10-year Treasury increased further during the first quarter to 281, from a historical wide of 270 at the end of 2009. While we currently feel that meaningful increases in inflation are several quarters away, we continue to evaluate tactical allocations to Treasury Inflation Protected Securities into our portfolio strategy.

FOR SEPARATELY MANAGED ACCOUNT INVESTOR OR PROFESSIONAL ADVISOR USE ONLY

*Estimated price-to-earnings ratios are based on information obtained from a third-party that is believed to be reliable. Estimates are only projections and not guarantees.

All data is as of 3.31.10 unless otherwise noted.

Past performance is no guarantee of future results. The information and statistical data contained in this material is general in nature and is not intended to provide personal investment advice or to be an endorsement of any specific investment. The information does not take into account the specific investment objectives, financial situation or particular needs of any specific person who may receive it. While the information presented is based on sources believed to be reliable, it is not guaranteed to be accurate and is subject to change. The indexes referenced are unmanaged market indexes. It is not possible to directly invest in an index.

100-3-88-6740210