International Small-Cap Equity Strategy Commentary
Third Quarter 2010

Market Environment

International small-cap equity markets rebounded strongly during the third quarter with the S&P® Developed ex-U.S. SmallCap Index reversing the second quarter's 10.7% decline with a 17.4% gain. The International Small-Cap Equity strategy performed well in this environment and finished ahead of the Index for the quarter. All countries within the Index posted a positive return. Although positive, Japan (2.9%) was the worst performing market as the Japanese exporters were hurt by a stronger yen, which reached a 15-year high of 82.88 vs. the U.S. dollar, prompting the Bank of Japan to intervene. Several countries in Europe had returns that exceeded 20% for the quarter. The region benefited from both strong earnings reports and results from European bank stress tests, which revealed that many of the European banks appear strong enough to withstand a potential downturn without government help. Sweden (33.7%) and Finland (32.6%) were the top performers in Europe. Germany (22.7%) surprised the market as second quarter GDP grew 9.0% (annualized) vs. consensus expectation of 5.3% (annualized). Asia Pacific was boosted by commodity-rich Australia (31.7%), as base metals copper and nickel gained 23% and 16.5% respectively. Strong performance from global commodities was also reflected in the sector returns, as energy (21.8%) and materials (21.4%) were the sector leaders. Information technology (13.1%) was the worst performing sector, with general market risk aversion in August hurting the sector more than others.

Portfolio Review

While the magnitude of the movement of Index returns during the second and third quarters was high, value- and earnings-related metrics remained stable, and exhibited positive trends. These characteristics were instrumental in providing the International Small-Cap Equity strategy with excess return from security selection in seven out of ten economic sectors in the third quarter. Relative performance was positive in the energy sector as well as the consumer discretionary sector, which generated solid relative performance, outperforming the sector by over 5%.

Outlook

While the macro environment has stabilized, there is still uncertainty going forward. The earnings growth picture globally is still quite robust over the next two fiscal years. After several years of cost cutting, many companies have positioned themselves for margin expansion. The International Small-Cap Equity strategy continues to focus on companies that exhibit improving business momentum with price multiples in a reasonable range given earnings expectations and sustainability.

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