

Market Environment

Stock markets around the world fell in the second quarter of 2010, driven by a jittery global investment community that perceived slowing global growth. The abundance of government debt in several countries caused the eurozone to significantly underperform the rest of the developed regions. Small-cap stocks in the European region declined more than in other regions during the quarter. Further evidence of turmoil in Europe was seen in the decline of the euro relative to the U.S. dollar during the quarter. The single currency region faces both economic and political challenges going forward.

For the second quarter of 2010, the S&P® Developed ex-U.S. SmallCap Index was down 10.72%. The large dispersion between country returns, which existed in the first quarter, continued in the second. The Greek stock market posted the largest decline, as stocks fell by 30.3%, on average, while the Japanese market was a relative bright spot, with stocks falling by 4.0%. All ten economic sectors of the Index posted negative overall returns for the quarter, with energy being the worst performing sector with a decline of 16.2%. Consumer staples (-6.5%) and telecommunication services (-7.3%) showed relative strength for the quarter, while financials (-11.8%) trailed the overall Index.

Portfolio Review

The international small-cap equity strategy trailed relative to its S&P benchmark by just over 50 basis points (0.5 percentage point) for the quarter, as solid outperformance through the first ten weeks of the quarter began to wane in the late quarter sell off. Security selection showed relative strength in six of ten sectors, with consumer discretionary and health care leading the way. As the sentiment in the market turned downward in the latter part of the quarter, the more cyclical sectors, such as industrials and materials, became a headwind for the strategy's performance.

Security selection in the industrials sector lagged relative to the Index. The defensive sectors of the strategy mitigated some of the negative impact from the more cyclical sectors, with particular strength in consumer discretionary and health care holdings.

Market Outlook

While we remain concerned about the abundance of government debt in several countries, we have seen improving trends in the top line growth of companies we analyze. One year ago, bottom line improvement was mainly due to cost cutting and government stimulus that will dissipate over time. Now there are improving trends in the quality of earnings that are being generated from new market share and general increased economic activity. Recognizing quality earnings growth will be key to generating excess returns. This investing environment is geared toward disciplined stock picking. Our bottom-up focus will continue to seek companies with higher quality business momentum at a price that may not yet reflect an improving environment for the company's potential.

Past performance does not guarantee future results.

Reflects information for a representative account that serves as the model against which all International Small-Cap Equity accounts are managed. The model portfolio is an actual account and the information provided will vary for other actual accounts. Portfolio holdings are subject to change. The S&P® Developed ex-U.S. SmallCap Index (formerly known as the S&P®/Citigroup Extended Market Index (EMI) World ex-U.S.) consists of the bottom 15% (based on market capitalization) of companies from each country other than the U.S. represented in the S&P® Developed Broad Market Index (BMI). The S&P® Developed BMI includes all listed shares of companies from 25 developed market countries with float-adjusted market capitalizations of at least US\$100 million and annual trading volume of at least US\$50 million. Index performance information was furnished by sources deemed reliable and is believed to be accurate, however, no warranty or representation is made as to the accuracy thereof and the information is subject to correction. You cannot invest directly in an index, securities in the Composite may not match those in the index and performance of the Composite will differ. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns.

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