

INTERNATIONAL EQUITY COMMENTARY

FIRST QUARTER 2010

International Markets

Equity markets delivered a solid quarter with many stocks surging in March and building on a rally that had its start twelve months prior in 2009. Both U.S. and international equity markets moved up during the quarter and emerging markets generated positive returns as well, despite a worrisome start this year for equity markets. Risk assets—which include the full array of equities, high yield and corporate bonds, and commodities – seemed to attract investors who have been bolstered by the global economic recovery, benefits of fiscal and monetary stimulus, and muted inflation. Overall, although economists have not specified the end of the recession, global economic recovery seemed to be in place with an emphasis on growth in developing countries. Production continued to rise as inventory reduction abated and unemployment seemed to stabilize. Given rising growth in both the US and globally, earning projections continued to advance. As the quarter drew to a close, sovereign debt was considered the contained crisis of the day, however, country risk is now firmly on the radar screen. Despite a global recovery, headwinds included unemployment, government debt, continued deleveraging by consumers, contraction of credit by banks, and the specter of rising interest rates.

The MSCI EAFE index was up 4.29% in local terms and 0.87% in USD terms. Index markets were generally mixed with major indices in Europe reporting in local terms: Austria 4.74%; Spain -10.18%; Italy -1.69%; and the United Kingdom 5.82%. In Asia, major country indices reported generally mixed performance as reflected by Japan 8.59%, Singapore -1.68%, and Hong Kong 2.57%, respectively. On a relative basis, the U.S. market outperformed global markets as the S&P 500 index returned 5.39% versus 0.87% for the MSCI EAFE Index in USD terms. Additionally, performance in emerging markets was positive but muted given the rally over the previous 12 months, with the MSCI Emerging Markets Index reporting 1.39% in local terms. From an international perspective, most sectors reflected significant positive performance over the quarter with the exception of Healthcare, Energy, Telecommunications, and Utilities.

Outlook and Positioning

Currently, the global recovery is perceived as more assured by investors despite critical components such as housing, jobs and incomes remaining weak. Positive momentum notwithstanding, we believe this recovery will need to be led by income and investment—not debt and consumption. Moreover, outside of Japan, operating leverage is relatively low and earnings could disappoint as working capital needs expand and input costs rise given a stabilizing global economy. We believe we are at a point where investor sentiment wavers between a wall of worry and a cliff of complacency. In short, many investors are starting to buy into the global recovery in a big way just as leading indicators such as earnings estimate upgrades and profit margins are beginning to peak. Despite many positive factors in the markets, we anticipate a very competitive business environment in many sectors with not enough growth to go around and the top two or three companies getting all of the orders. For many companies, input costs are rising and competition is reducing pricing power resulting in difficult top line growth. In short, there will be not enough growth to go around for quite a few firms in 2010. We continue to believe that a key issue going forward is the sustainability of earnings versus what appear to be unrealistic expectations currently. Global earnings estimates reflect record margins in the next 12 months with much of the cash flows and profits driven by unsustainable working capital changes. We see real opportunities in quality companies that deliver high return on equity, top tier sales growth, high free cash flow and low volatility. Many of these companies, located in the major developed markets, are trading at unusually low relative valuations.

We believe we are experiencing range-bound markets currently, exhibited by the seesaw action of declines in January followed by rising stock prices in March. Finding stocks that outperform in such markets is a challenging endeavor and favors an active equity approach. In range bound markets the drivers of growth and total return are dividends and dividend growth, top line growth driven by volumes, recurring revenues, strong balance sheets, funded capital expenditures, and consolidation of capacity. We believe we can secure



better gains from companies that are industry and sector leaders exhibiting low valuation on earnings and solid cash flows.

Current portfolio positioning can be characterized as a ‘tri-bell’ approach with one key theme: resilience. We have built a balanced strategy that prepares the portfolio for global growth and recovery, but also takes into account the potential for challenges and setbacks before we arrive at a bull market supporting overall fundamentals. Resilience requires sustainable cash flows and high quality internal growth drivers that provide a competitive edge for companies within an industry. Currently, our investment strategy invests capital across defensive stocks, select cyclicals and special situation opportunities. The defensive stocks we seek tend to be high quality with a record of solid and stable cash flows and internal growth drivers that are not tied to the pace of global economic activity. The cyclical stocks we seek are selected with close consideration that the earnings and valuations meet defined criteria given where we are in the cycle for these stocks. Special opportunities are likely to include high quality stocks where the market has ignored growth potential and internal drivers that show the potential for reversion to previous valuation levels. On a sector basis, we are finding interesting stocks in consumer discretionary, technology and telecommunications. On a regional basis we are seeking specific opportunities in Asia ex Japan, Japan and North America.

We don’t attempt to predict the future, but instead attempt to take advantage of those who think they can. China is likely to move into a structural, cyclical slowdown where growth will disappoint. China market based reforms are 30 years old and the country has overbuilt and over invested relative to peers, which is unsustainable. The developments in China support our thesis that the best returns will be garnered not from scarcity investments, but instead from companies that benefit from abundance and efficiencies.

We anticipate that the positive momentum of economic recovery will potentially benefit many stocks, although we feel that that this is a time for bottom up stock picking and differentiating the winners from the losers. We believe that the current environment supports an active management approach where fundamental factors will play a larger role in market returns going forward. To manage risk, we continue to build in a margin of safety into our portfolio construction process. Our investment approach is centered on a bottom up, active investment process using a combination of quantitative, qualitative and fundamental analysis. As we look ahead to the balance of 2010, we believe we have the tools, disciplines and people in place to position the portfolio to take advantage of opportunities in order to deliver value to our clients.

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Performance returns and other data are current as of March 31, 2010.