

INTERNATIONAL EQUITY COMMENTARY

SECOND QUARTER 2010

International Markets

A global market correction that ramped up in mid-April and gained momentum in the final days of June caused many stocks to decline significantly during the quarter. Investors caught in the line of fire juggled multiple fears caused by troubling news from around the world. Both U.S. and global equity markets moved downward during the quarter and emerging markets declined as well. Fear seemed to rule the day as investors worried about a range of concerns including a global economic slowdown, slumping consumer confidence, China's growth prospects, and the solvency of European banks. What had previously been seen as a heightened interest in risk assets reversed with many investors seeking out safe investments as the quarter drew to a close. Volatility appeared to be on the rise as the Chicago Board Options Exchange Volatility Index – widely known as the 'fear gauge,' – soared during April and May, fell back during June and then spiked as the quarter ended. Global fears also impacted commodity prices as well, with copper, for example, off double digits for the year. Overall, most economists and strategists believe that a double-dip recession is unlikely. However, the combination of poor consumer confidence, weak job creation, and fiscal spending hurdles suggest that the global economy could stumble in the second half of the year and deliver lower growth as compared to the first half of 2010. Moreover, in the U.S. where interest rates are at historic lows, the Federal Reserve lacks the ability to cut rates to stimulate a faltering economy. The economic travails have caused many investors to stay on the sidelines and increasingly, the uncertainty in the marketplace has caused many business executives to hunker down instead of pursuing growth and expansion. On the positive side, incomes have been rising, corporate cash flows are strong, and the industrial recovery has been solid in an economic environment that has reflected low interest rates and tempered inflation.

The MSCI EAFE index was down -11.15% in local terms and -13.97% in USD terms. Index markets were generally negative with major indices in Europe reporting in local terms: Austria -14.26%; Spain -12.49%; Italy -13.38%; and the United Kingdom -12.65%. In Asia, major country indices reported generally negative performance as reflected by Japan -14.84%, Singapore -0.12%, and Hong Kong -5.55%, respectively. On a relative basis, the U.S. market outperformed international markets as the S&P 500 index returned -11.43% versus -13.97 for the MSCI EAFE Index in USD terms. Additionally, performance in emerging markets declined, however, less than developed markets, with the MSCI Emerging Markets Index reporting -5.61% in local terms. From an international perspective, all sectors reflected significant negative performance over the quarter as measured by the MSCI indexes.

Outlook and Positioning

Currently, we believe the slowdown in the global recovery is the result of a material loss of momentum, but not the beginning of a double-dip recession. The recovery to date has been somewhat of a disappointment – not the instant recovery that was desired – but more a process of arresting the decline of the recession. Recent disappointments in job growth and income indicators do not bode well for robust economic growth in the near term. Also, the combination of 2011 tax increases and year-over-year declines in stimulus spending will be a drag on economic growth going forward. Policy risks include the potential for government representatives to print money, elevate borrowing, and increase the deficit — which will work against economic growth and potentially destabilize the bond and currency markets.

For the markets, our assessment is that value factors underperformed during the quarter, especially in Australia and Europe. In contrast, quality factors outperformed, especially in Japan and the U.S. Earnings growth will be challenged if the pace of economic growth moderates during the balance of 2010. In short, the premium for growth is expanding in an environment where growth is hard to come by. We continue to anticipate a very competitive business environment in many sectors with not enough growth to go around and the top two or three companies likely to receive all of the orders. Also, we expect that the hunt for external growth in combination with strong balance sheets will support M&A activity going forward. On the positive front, we believe that the austerity measures and financial support taking place in Europe appears constructive – reality is beginning to set in. The G20 meeting provided evidence of solidarity in the



'cut the deficit' pledge and in the realization that significant time and resources will be required to address global economic hurdles. Evidence continues to build that Emerging Markets, especially Asia, are growing incomes and moving from export driven to internal demand driven economies. Accordingly, we continue to seek business opportunities that originate from the growth of emerging market consumers. Although we are cautious about commodities in general, we believe that there is steady structural demand in agricultural commodities, specifically food, in response to rising incomes and the propensity for human beings to eat meat as they climb the economic ladder.

The sustainability of earnings versus what appears to be unrealistic expectations currently will be a key issue in the second half of this year and into next year. With 2011 and 2012 earnings estimates vulnerable, the prospects for the current market leadership — low quality cyclicals and commodities — appears to be waning. We believe that the new leadership will be comprised of high quality companies that deliver high return on equity, top tier sales growth, high free cash flow and low volatility. Many of these firms are located in the major developed markets, generate significant product demand and are trading at unusually low relative valuations.

Resilience is a main theme characterizing our current portfolio positioning. Our investment strategy invests capital across defensive stocks, special situation opportunities, and select cyclicals. The defensive stocks are generally high quality companies with a record of stable cash flows, consistent internal growth drivers and a leading franchise in the relevant marketplace. Special opportunities tend to include high quality stocks where the market has ignored growth potential and internal drivers that show the potential for rerate to previous valuation levels. We are very selective with cyclical stocks and seek companies that reflect earnings and valuations in line with defined criteria — given where we are in the cycle for these stocks. 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. Resilience requires sustainable cash flows and high quality internal growth drivers that provide a competitive edge for companies within an industry. Generally, the cyclical stocks in the portfolio have declined in value recently however, the defensive and special opportunity stocks that we hold tend to have higher quality and have risen in value. Overall, we would anticipate this trend continuing and we expect to add to higher quality opportunities going forward.

In volatile markets, we believe that an active management approach that incorporates fundamental factors will play a significant role in market returns. The market correction has created near-term opportunities to build meaningful long-term positions in quality companies at very low valuations. 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, stock picking using a combination of quantitative, qualitative and fundamental analysis. As we look ahead to the second half of 2010, we believe we have positioned the portfolio to take advantage of opportunities in order to deliver value to our clients.

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