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## Using Secondary Benchmarks to Improve Portfolio Structure

Security valuation is typically viewed as the more glamorous aspect of an investment process, while portfolio construction and implementation are viewed as relatively more pedestrian. However, it's not enough to have informed insights into the individual attractiveness of a universe of securities; it's equally important how those insights are captured and translated into a well-structured portfolio aimed at satisfying client and strategic objectives.

Our portfolio risk management process is focused on active risk — i.e., how our assessments of individual security attractiveness lead our portfolio to beta, industry, individual security and other characteristic departures from the primary benchmark's profile. For some of our strategies' portfolios we are also interested in managing departures from a secondary benchmark. Specifically, we make use of primary as well as secondary benchmarks when constructing the portfolios for our tax-managed and socially responsible strategies.

### Incorporating Secondary Benchmarks

The use of secondary benchmarks is beneficial in addressing situations where a strategy has a clearly identified second point of reference which is important to consider in addition to the strategy's primary

performance benchmark. When constructing a typical portfolio relative to a single primary benchmark, a single optimal portfolio will not exist; instead, there will be several similarly optimal portfolio solutions available. When a meaningful secondary benchmark is introduced, a manager can effectively narrow the choice among the similarly optimal portfolios by selecting the portfolio that coincidentally yields the best fit relative to both the primary and secondary benchmarks. This approach of using both primary and secondary benchmarks allows us to explicitly manage exposures to the characteristics of two benchmarks simultaneously.

A common use of secondary benchmarks for managers is during portfolio optimization when managing a portfolio through an anticipated benchmark reconstitution. For instance, in a strategy that is closely managed to one of the Russell indexes, which undergo regular reconstitutions, the manager can incorporate the preliminarily announced version(s) of the reconstituted index as a secondary benchmark while continuing to use the current, pre-reconstituted index as the primary benchmark. This approach will allow the manager to properly anticipate the impact of reconstitution, which will aid in minimizing the jump in risk that would occur once the index reconstitution actually takes effect.

### Firm Overview

- A pioneer in advanced quantitative investment strategies
- Founded in 1996
- Based in Safety Harbor, FL
- Majority-owned affiliate of State Street Global Alliance, LLC
- Principals own meaningful equity stake
- Manages approximately \$1 billion for clients in the US and Europe
  - MaxCap
  - MaxCap Value
  - LargeCap
  - LargeCap Socially Responsible
  - AllCap
  - TaxManaged AllCap
  - TaxManaged LargeCap
  - SMidCap

At Advanced Investment Partners, we have successfully incorporated secondary benchmarks within the management of our TaxManaged LargeCap, TaxManaged AllCap and Socially Responsible LargeCap strategies. For example, our TaxManaged LargeCap strategy has the S&P 500 as a primary benchmark, but it also employs a secondary benchmark of the regular, non-tax-managed LargeCap portfolio. The objective for our TaxManaged LargeCap strategy is to outperform the S&P 500 Index in a tax efficient manner while looking as much like the non-tax managed LargeCap portfolio as possible. Therefore, the management of a client's TaxManaged LargeCap portfolio is a triangulation of sorts between the S&P 500 Index, the non-tax managed LargeCap portfolio, and the client's current portfolio of taxable holdings.

Similar to the TaxManaged LargeCap strategy, our Socially Responsible LargeCap strategy has the S&P 500 as a primary benchmark and the regular LargeCap strategy's portfolio as a secondary benchmark. The Socially Responsible LargeCap strategy's

objective is to outperform the S&P 500 using only stocks of socially responsible companies while looking as much like the regular LargeCap portfolio as possible. For this strategy the portfolio is a triangulation of the S&P 500, the regular LargeCap portfolio, and a universe of stocks that have been individually evaluated for social responsibility.

A useful analogy for portraying the impact on a strategy's portfolio when primary and secondary benchmarks are employed is the orbital relationship between the sun, earth and moon. For illustrative purposes the sun will represent the primary benchmark, the earth the secondary benchmark and the strategy's managed portfolio the moon (see Chart 1).

The moon orbits both the sun and the earth, but its orbit around the earth is much tighter. Similarly, our tax-managed and socially responsible strategies' portfolios have managed departures from both the primary and secondary benchmarks, but the departures from the secondary benchmark is at a much lower level of active risk than the active risk relative to the strategy's primary

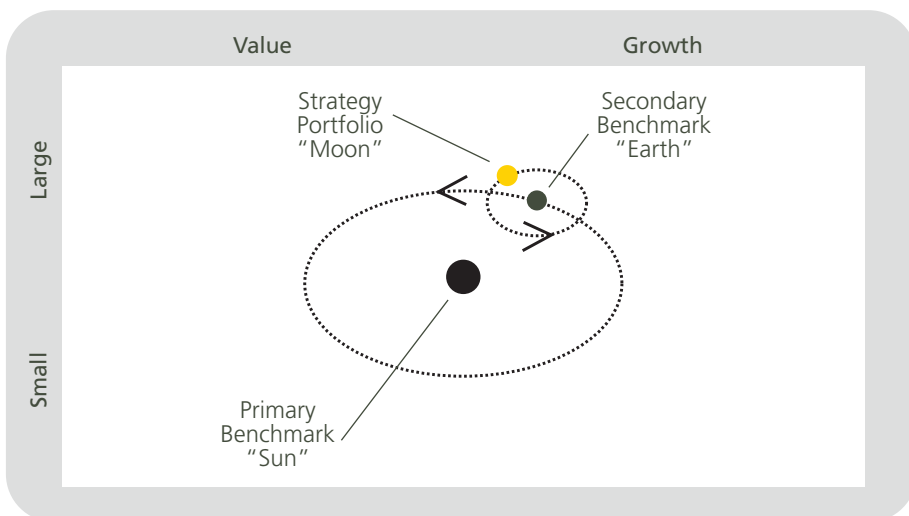
benchmark. This structure for constructing our tax-managed and socially responsible portfolios allows us to maintain characteristics very close to the underlying strategy while satisfying the additional objectives of tax management and social responsibility, respectively.

During 2007 we also implemented a secondary benchmark within the portfolio management process for our regular AllCap strategy. The following discussion details our considerations during this strategy enhancement as a case study to further clarify the benefits of using secondary benchmarks.

### Case Study: Introducing a Secondary Benchmark into the AllCap Strategy

Our AllCap strategy is a core strategy benchmarked to the Russell 3000® Index and is structured as a distillation of the combined LargeCap and SMidCap strategy portfolios. The LargeCap portfolio (typically with 65 positions) and the SMidCap portfolio (typically with 130 positions) are distilled into an AllCap portfolio (typically holding about 60 positions) by optimally sampling the higher expectation holdings from the individual LargeCap and SMidCap portfolios. Given that our AllCap portfolio draws upon the LargeCap and SMidCap holdings, our expectation is for AllCap's benchmark-relative performance to be between the other two strategies with perhaps greater similarity with the LargeCap performance due to the high degree of overlap between their benchmarks — the S&P 500 and the Russell 3000®, respectively.

Chart 1



As the first half of 2007 began to unfold, we observed a growing negative divergence in AllCap performance relative to the performance of LargeCap and SMidCap. In response, we initiated a full review of our AllCap portfolio management process to clearly attribute the sources of the divergence and to identify possible enhancements to our AllCap investment process that would minimize expected future divergences.

*AllCap Departures from LargeCap and SMidCap*

Although the AllCap holdings were sourced from the higher expectation positions from the LargeCap and SMidCap portfolios, there were material differences in aggregate portfolio characteristics. Of particular note were differences in sector weights, especially the Energy, Technology and Health Care sectors. There were differences in the portfolios' betas as well. Although the AllCap portfolio had a great deal of position overlap with the LargeCap and SMidCap portfolios, the aggregate characteristics evidenced sector

differences as a source of performance departure between the three strategies. Therefore, we needed to go beyond ensuring similarity in portfolio positions and enhance our ability to foster greater similarity of portfolio characteristics.

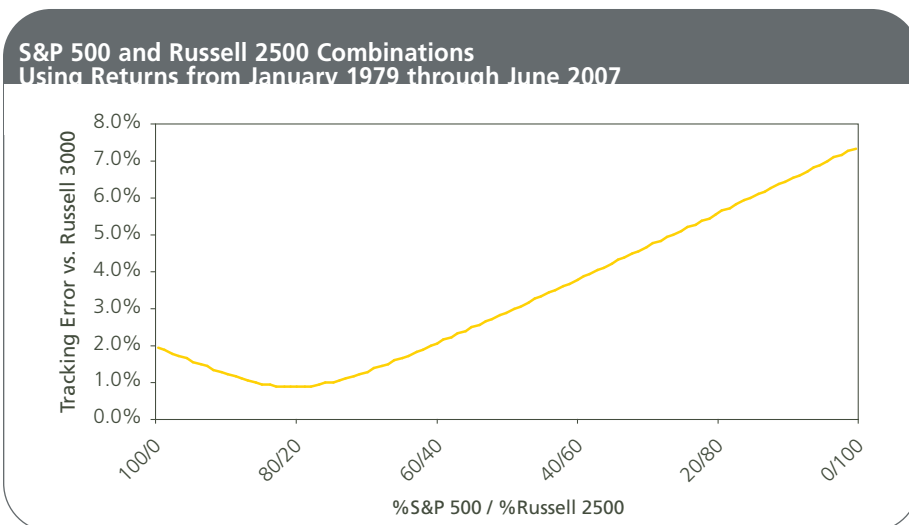
*Initiating a Secondary AllCap Benchmark: LargeCap + SMidCap Aggregate*

To minimize divergence in portfolio characteristics, it is necessary to be more precise about which stocks are held and in what position sizes. Sampling the more significant high expectation stocks from the LargeCap and SMidCap portfolios and weighting them appropriately should yield an AllCap portfolio with similar overall portfolio characteristics and biases as those found in the LargeCap and SMidCap portfolios. We believed that this could be accomplished by introducing a secondary benchmark for the AllCap strategy — the primary benchmark would remain the Russell 3000® while a secondary benchmark would be established as a LargeCap plus SMidCap aggregate portfolio.

The first step in establishing this secondary benchmark was determining the appropriate proportions when combining the individual LargeCap and SMidCap portfolios into an aggregate portfolio. This was done by looking at all possible combinations of each strategy's benchmark returns (i.e., the S&P 500 for the LargeCap and the Russell 2500® for the SMidCap) and evaluating which combination most closely approximated the returns for the Russell 3000®. Chart 2 shows the result of this analysis when performed in July 2007.

The chart reveals that the closest fit to the Russell 3000® is an 80/20 proportional combination of the S&P 500 and the Russell 2500®. Therefore, the secondary benchmark for the AllCap strategy was established as an 80/20 combination of the LargeCap and SMidCap portfolios. This explicit linkage via a secondary benchmark should provide a measure of direct control on the AllCap portfolio's departure from its two related strategies' portfolios.

Chart 2



## MaxCap

Contact firm for information on MaxCap Value.

## LargeCap

### Benchmark

S&P 100

S&P 500

### Quarterly Performance Attribution<sup>3</sup>

#### Best Active Performance Policies:

- Style – Overweight Momentum; Underweight Value, Yield and Leverage
- Sector – Underweight Financials; Overweight Energy
- Industry – Overweight Energy Reserves; Underweight Banks and Home Products
- Stocks – Underweight General Electric; Overweight Goldman Sachs, Baxter International, El Paso Corporation and McDonald's

#### Worst Active Performance Policies:

- Style – Overweight Size
- Sector – Underweight Telecommunications; Overweight Consumer Services
- Industry – Underweight Telephone and Electric Utility; Overweight Oil Services
- Stocks – Overweight ExxonMobil, FedEx, Raytheon and NYSE Euronext; Underweight Apple

#### Best Active Performance Policies:

- Style – Overweight Momentum; Underweight Value, Yield and Size
- Sector – Underweight Financials and Consumer Non-Cyclicals; Overweight Basic Materials
- Industry – Underweight Banks and Home Products; Overweight Mining and Metals
- Stocks – Overweight Consol Energy, Fluor, Mosaic and Northern Trust; Underweight General Electric

#### Worst Active Performance Policies:

- Style – Underweight Earnings Yield
- Sector – Underweight Utility; Overweight Consumer Services
- Industry – Overweight Entertainment; Underweight Electric Utilities
- Stocks – Overweight Diamond Offshore, ExxonMobil, Viacom (B), Lennar and Eli Lilly

### Portfolio Content

Universe ..... S&P 100  
Trailing 12-month Turnover ..... 64%  
Number of Holdings ..... 33  
Cash Level ..... 2.3%

Universe ..... S&P 500 + 400 largest in Russell 1000  
Trailing 12-month Turnover ..... 103%  
Number of Holdings ..... 61  
Cash Level ..... 1.2%

### Top 10 Holdings<sup>3</sup>

- ExxonMobil
- Chevron
- IBM
- Microsoft
- Wal-Mart

- Hewlett-Packard
- Intel
- PepsiCo
- Baxter International
- Abbott Labs

- ExxonMobil
- Chevron
- Wal-Mart
- Google
- Consol Energy

- Celgene
- Fluor
- Hewlett-Packard
- Intel
- Diamond Offshore Drilling

### Portfolio Characteristics<sup>3</sup>

Barra Risk Factors	MaxCap	S&P 100	Difference
Currency Sensitivity	0.11	0.10	0.01
Earnings Variation	-0.19	-0.13	-0.06
Earnings Yield	0.18	0.15	0.03
Growth	-0.10	-0.16	0.06
Leverage	-0.41	-0.28	-0.13
Momentum	0.03	-0.11	0.14
Size	0.96	0.92	0.04
Trading Activity	-0.19	-0.13	-0.06
Value	-0.17	-0.05	-0.12
Volatility	-0.35	-0.26	-0.09
Yield	0.10	0.23	-0.13

Barra Risk Factors	LargeCap	S&P 500	Difference
Currency Sensitivity	-0.04	0.01	-0.05
Earnings Variation	0.04	-0.06	0.10
Earnings Yield	-0.05	0.08	-0.13
Growth	0.06	-0.09	0.15
Leverage	-0.24	-0.14	-0.10
Momentum	0.16	-0.03	0.19
Size	0.28	0.37	-0.09
Trading Activity	0.07	0.02	0.05
Value	-0.17	-0.04	-0.13
Volatility	-0.05	-0.13	0.08
Yield	-0.08	0.07	-0.15

### Sector Weights<sup>3</sup>

Sector Weights	MaxCap	S&P 100	Difference
Consumer Discretionary	6.4%	5.6%	0.8%
Consumer Staples	8.1	11.3	-3.2
Energy	19.2	15.8	3.4
Financials	12.8	14.8	-2.0
Health Care	15.1	11.9	3.2
Industrials	4.6	6.3	-1.7
Materials	1.2	3.4	-2.2
Retail	6.2	4.0	2.2
Services	3.7	6.5	-2.8
Technology	22.6	18.3	4.3
Utilities	0.1	2.1	-2.0

Sector Weights	LargeCap	S&P 500	Difference
Consumer Discretionary	8.4%	6.1%	2.3%
Consumer Staples	4.3	9.0	-4.7
Energy	14.5	15.0	-0.5
Financials	13.4	15.2	-1.8
Health Care	17.2	12.2	5.0
Industrials	2.2	7.1	-4.9
Materials	6.1	5.4	0.7
Retail	7.4	4.9	2.5
Services	8.0	5.7	2.3
Technology	18.5	15.7	2.8
Utilities	0.0	3.7	-3.7

### Performance (as of 06.30.08)

Performance	MaxCap Pure Gross of Fees <sup>2</sup>	MaxCap Net of Fees	S&P 100
Second Quarter 2008 <sup>1</sup>			
Year to Date 2008 <sup>1</sup>			
Annualized Total Return	For performance data, contact Laurie Watson at (888) 248-8324		
1 year			
3 years			
5 years			
Since Inception <sup>1</sup>			
Inception Date – 07.01.98			

Performance	LargeCap Pure Gross of Fees <sup>2</sup>	LargeCap Net of Fees	S&P 500
Second Quarter 2008 <sup>1</sup>			
Year to Date 2008 <sup>1</sup>			
Annualized Total Return	For performance data, contact Laurie Watson at (888) 248-8324		
1 year			
3 years			
5 years			
Since Inception <sup>1</sup>			
Inception Date – 05.01.99			

## AllCap

Russell 3000

### Best Active Performance Policies:

- Style – Overweight Momentum; Underweight Size, Value and Yield
- Sector – Overweight Financials and Technology; Underweight Consumer Non-Cyclicals
- Industry – Underweight Banks and Home Products
- Stocks – Overweight Energy Conversion Devices, Fluor, Consol Energy, Western Union and UMB Financial

### Worst Active Performance Policies:

- Style – Underweight Size Non-Linearity
- Sector – Overweight Energy and Consumer Services; Underweight Utilities
- Industry – Underweight Energy Reserves; Overweight Entertainment
- Stocks – Overweight Diamond Offshore, Fresh Del Monte Produce, Hewitt Associates, OM Group and CME Group

Universe ..... Russell 3000  
Trailing 12-month Turnover ..... 117%  
Number of Holdings ..... 65  
Cash Level ..... 0.3%

- Chevron
- Wal-Mart
- Google
- Diamond Offshore Drilling
- Microsoft

- Intel
- IBM
- Energy Conversion Devices
- Western Union
- Hewitt Associates

Barra Risk Factors	AllCap	Russell 3000	Difference
Currency Sensitivity	0.08	0.00	0.08
Earnings Variation	0.03	0.01	0.02
Earnings Yield	-0.04	0.02	-0.06
Growth	0.12	-0.01	0.13
Leverage	-0.14	-0.01	-0.13
Momentum	0.29	0.02	0.27
Size	-0.18	-0.04	-0.14
Trading Activity	0.03	0.02	0.01
Value	-0.13	-0.01	-0.12
Volatility	0.07	0.01	0.06
Yield	-0.16	-0.01	-0.15

Sector Weights	AllCap	Russell 3000	Difference
Consumer Discretionary	7.6%	6.8%	0.8%
Consumer Staples	4.3	8.0	-3.7
Energy	13.2	14.0	-0.8
Financials	15.4	15.5	-0.1
Health Care	12.1	11.9	0.2
Industrials	3.8	7.6	-3.8
Materials	7.4	6.0	1.4
Retail	6.5	4.8	1.7
Services	11.2	6.3	4.9
Technology	18.5	15.2	3.3
Utilities	0.0	3.9	-3.9

Performance	AllCap Pure Gross of Fees <sup>2</sup>	AllCap Net of Fees	Russell 3000
Second Quarter 2008 <sup>1</sup>	<div style="border: 1px solid black; padding: 5px; text-align: center;">                     For performance data, contact Laurie Watson at (888) 248-8324                 </div>		
Year to Date 2008 <sup>1</sup>			
Annualized			
Total			
Return			
			Since Inception <sup>1</sup>
Inception Date – 01.01.97			

## SMidCap

Russell 2500

### Best Active Performance Policies:

- Style – Overweight Momentum; Underweight Value, Yield and Leverage
- Sector – Overweight Financials and Transports; Underweight Consumer Cyclicals
- Industry – Overweight Oil Services and Railroads; Underweight Banks and Motor Vehicles and Parts
- Stocks – Overweight Energy Conversion Devices, CF Industries Holdings, Terra Industries, Dreamworks Animation and Janus Capital Group

### Worst Active Performance Policies:

- Style – Underweight Non-Estimate Universe
- Sector – Underweight Basic Materials and Energy; Overweight Consumer Services
- Industry – Underweight Energy Reserves and Mining and Metals; Overweight Entertainment and Securities and Asset Management
- Stocks – Overweight Fresh Del Monte, OM Group, Pediatrix Medical Group, Greenhill and Company and J.Crew Group

Universe ..... Russell 2500  
Trailing 12-month Turnover ..... 103%  
Number of Holdings ..... 125  
Cash Level ..... 1.2%

- Atwood Oceanics
- CF Industry Holdings
- W-H Energy Services
- Energy Conversion Devices
- Kansas City Southern

- Janus Capital Group
- Terra Industries
- Dreamworks Animation
- Rock-Tenn
- KBR

Barra Risk Factors	SMidCap	Russell 2500	Difference
Currency Sensitivity	-0.16	-0.05	-0.11
Earnings Variation	0.19	0.23	-0.04
Earnings Yield	-0.17	-0.26	0.09
Growth	0.14	0.22	-0.08
Leverage	0.41	0.55	-0.14
Momentum	0.26	0.12	0.14
Size	-2.02	-1.93	-0.09
Trading Activity	0.22	0.10	0.12
Value	0.04	0.13	-0.09
Volatility	0.60	0.63	-0.03
Yield	-0.44	-0.29	-0.15

Sector Weights	SMidCap	Russell 2500	Difference
Consumer Discretionary	11.6%	9.0%	2.6%
Consumer Staples	2.1	2.9	-0.8
Energy	7.9	9.2	-1.3
Financials	19.2	17.0	2.2
Health Care	9.9	10.8	-0.9
Industrials	9.6	10.3	-0.7
Materials	9.3	9.1	0.2
Retail	3.5	5.2	-1.7
Services	13.2	8.1	5.1
Technology	12.2	13.4	-1.2
Utilities	1.5	5.0	-3.5

Performance	SMidCap Gross of Fees	SMidCap Net of Fees	Russell 2500
Second Quarter 2008 <sup>1</sup>	<div style="border: 1px solid black; padding: 5px; text-align: center;">                     For performance data, contact Laurie Watson at (888) 248-8324                 </div>		
Year to Date 2008 <sup>1</sup>			
Annualized			
Total			
Return			
			Since Inception <sup>1</sup>
Inception Date – 11.01.02			

*Observed Impact  
on Performance Divergence*

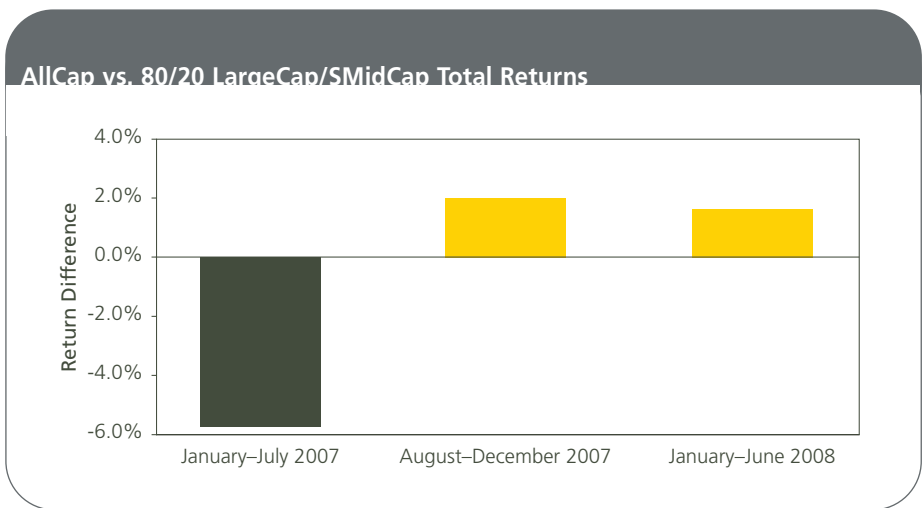
The incorporation of a secondary benchmark into the AllCap portfolio management process was initiated in late July 2007. Chart 3 compares the difference in the AllCap strategy's total return versus an 80/20 combination of the LargeCap and SMidCap strategies' total returns for three periods:

1) January through July 2007, which was prior to the usage of a secondary benchmark; 2) August through December 2007, which is the balance of calendar 2007 using the secondary benchmark; and 3) year-to-date 2008 through June. The first period displays the performance divergence observed in 2007 while the other two periods reveal the positive impact to date on divergence resulting from the implementation of the 80/20 LargeCap/SMidCap secondary benchmark for the AllCap strategy.

Chart 3 reveals that the AllCap strategy's negative divergence in performance from the LargeCap and SMidCap strategies was favorably corrected through the remainder of calendar 2007 and has continued through June 2008. The secondary benchmark has fostered much more similarity between the three portfolios — not just in individual positions, but also across overall portfolio characteristics.

Although not a common practice, we have realized portfolio structure benefits from incorporating secondary benchmarks in conjunction with primary benchmarks when constructing the portfolios for our tax-managed and socially responsible strategies, and now our AllCap strategy.

Chart 3



## Notes to Composite Performance Presentations

Advanced Investment Partners is a registered investment advisor specializing in the professional management of investment portfolios utilizing advanced quantitative techniques. The firm claims compliance with the Global Investment Performance Standards (GIPS®).

Beginning January 1, 2000, Advanced Investment Partners has engaged independent accountants to verify the firm's compliance with GIPS and to perform individual performance exams for the firm. To receive a complete list and description of the firm's composites and/or a presentation that adheres to the GIPS Standards, contact Advanced Investment Partners at (727) 799-3671 or write to Advanced Investment Partners, 100 Main Street Suite 301, Safety Harbor, FL 34695.

In each of its investment strategies, the firm seeks to outperform the stated benchmark over time through superior stock selection combined with rigorous, precise portfolio risk management. Accounts under each composite strategy will hold a diversified portfolio of common stocks that in aggregate exhibit investment characteristics and industry representations similar to those of the strategy's benchmark index. Performance results represent a market value-weighted composite of all discretionary accounts under the respective investment strategy, calculated on a time-weighted basis for cash flows on a monthly basis, including the reinvestment of dividends, interest and capital gains. Historical portfolio returns are calculated by linking individual monthly returns. Pure gross of fee returns do not reflect the deduction of investment management fees or bundled fees for certain accounts where transaction costs cannot be separately identified from other service fees charged by the client's broker/dealer or outside custodian. Gross of fee returns deduct transaction fees but do not take into account investment management fees, brokerage fees or bundled fees paid for certain accounts where transaction costs cannot be separately identified from other service fees charged by the client's broker/dealer or custodian. Net of fee returns reflect the deduction of investment management fees, brokerage fees and bundled fees as applicable.

Composite returns, both historic and future, will be impacted by the same material market and economic conditions that influence the benchmark index. All returns have been calculated in US dollars. COMPOSITE RETURNS REPRESENT PAST PERFORMANCE AND ARE NOT PREDICTIVE OF FUTURE RESULTS.

Each strategy's performance composite and related benchmark index are defined as follows:

### LargeCap-Institutional Composite

includes all discretionary accounts greater than \$3 million managed under the LargeCap strategy where the firm is authorized with best execution trading responsibility. The LargeCap institutional composite is benchmarked to the S&P 500 Index, a broad based market value weighted index of 500 stocks chosen by committee at Standard and Poor's Corp. for their size and industry characteristics.

**AllCap Composite** includes all non-wrap discretionary accounts managed under the AllCap strategy and is benchmarked to the Russell 3000 Index. The Russell 3000 Index is an index of US stocks that represents approximately 98% of the US equity market's total capitalization.

**MaxCap Composite** includes all discretionary accounts managed under the MaxCap Strategy and is benchmarked to the S&P 100 Index. The S&P 100 Index is widely regarded as a standard for measuring the performance of 100 of the very largest capitalization US stocks as chosen by committee at Standard and Poor's Corp. for their size and industry characteristics.

**SMidCap Composite** includes all discretionary accounts managed under the SMidCap strategy. The SMidCap composite is benchmarked to the Russell 2500 Index, which measures the performance of the 2,500 smallest companies in the Russell 3000 Index and represents approximately 17% of the total market capitalization of the Russell 3000 Index.

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