

LargeCap Strategy

Q4 2009 INVESTMENT UPDATE



Market Overview

US Equities

If Rip Van Winkle nodded off under a shade tree on December 31st, 2008, and slept 5% as long as depicted in his legendary tale, he'd be reading of broad US equity advances totaling 20-40% (depending on the index). And he'd likely have a less furrowed brow—and fewer gray hairs—than those of us who were white-knuckled under the green lampshade all year. This was an exciting—if at times harrowing—ride.

After a bit of a breather in the early half Q4, the final month of 2009 saw a return to the high risk/low quality rally which began on March 10th. We have considerable disdain for the phrase “window dressing”, but in this case, the shoe fits. When taken on the whole, the fourth quarter showed a relative increase in risk aversion for the first time since the market bottomed last spring. Contrary to the prior two quarters, stocks in the larger end of the market cap spectrum performed best last quarter, and the smallest stocks were laggards. To wit, the **Russell Top 200® Index** advanced 6.1%, followed closely by the large-cap **Russell 1000® Index** (up 6.0%). Small-cap stocks, while still recording a sizeable gain of 3.9%, were the worst performing cap group.

Growth stocks are seen as higher quality issues, and the relative increase in risk aversion contributed to these stocks leading the pack. Within each market capitalization segment, growth stocks outstripped their value counterparts. The best-performing style group was mega-cap growth; the **Russell Top 200® Growth Index** surged 8.4%. The worst-performing style group was small-cap value stocks; the **Russell 2000® Value Index** advanced 3.6% nonetheless.

The **Financial** sector took a breather from its heady recovery of the prior 6 months, posting the worst performance of any sector within the large-cap Russell 1000 Index (-2.6%). **Consumer Staples** was the next-worst performer, albeit recording a 4.9% advance. **Information Technology** held its post as the performance stalwart of 2009, advancing an additional 10.8% to finish the year 61.9% higher.

Portfolio Review

We were slightly ahead of the **S&P 500®** during the final quarter of 2009, but did not outperform by a wide enough margin to make up for the prior six months (particularly the first half of that period). As a result, we finished 2009 nearly 2% behind the S&P 500 Index.

Several exposures served to boost active performance during Q4. Among these were a slight underweight to **Health Care** stocks, slight overweights to **Basic Materials** and **Consumer Services**, and solid stock selection. New positions which performed best during the quarter include specialty metal producer **Allegheny Technologies (ATI)**, coal concern **Peabody Energy (BTU)**, and diversified oil and gas company **Occidental Petroleum (OXY)**. ATI has topped the S&P 500 by nearly 18% since being added to the portfolio on December 15th; BTU and OXY have topped the index by 3.0% and 2.5%, respectively, since purchase.

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Firm Overview

- A pioneer in advanced quantitative investment strategies
- Founded in 1996
- Principals own meaningful equity stake
- Manages the following strategies for clients in the US and Europe:
 - MaxCap
 - MaxCap Value
 - LargeCap
 - Sustainable Responsible LargeCap
 - AllCap
 - TaxManaged AllCap
 - TaxManaged LargeCap
 - SMidCap

As during the previous three quarters, the portfolio's exposure to lower-beta stocks impaired active performance. Interestingly, the portfolio's greater-than-benchmark exposure to earnings variation also detracted from active performance. Low beta is one proxy for risk aversion, and higher earnings variability is one proxy for higher risk; one would not have expected to be penalized for both exposures. A few new positions in the portfolio did not perform to our expectations in the short run. We purchased credit card issuer **Discover Financial Services** (DFS) in mid-December, and the position has underperformed the S&P 500 by 8.6%. Earlier in the quarter we purchased stakes in diversified financial services company **PNC Financial** (PNC) as well as **Colgate Palmolive** (CL). Each of these positions trailed the benchmark by over 4.5% since purchase.

Portfolio Changes

We increased the portfolio's exposure to the Financial sector by about 2.5% during the fourth quarter via new positions in **IntercontinentalExchange** (ICE), **PNC Financial** (PNC), **Public Storage** (PSA), and **Discover Financial Services** (DFS). The portfolio has a four percent overweight to Financials relative to the S&P 500's. We also added to our holdings in the Consumer Staples sector. Here, we opened a position in **Colgate Palmolive** (CL) and added to positions in **Philip Morris** (PM) and **Procter & Gamble** (PG). We are about 4% overweight the Consumer Staples sector.

Top Active Weights - 12/31/09

Top Five Overweights vs. S&P 500	Portfolio
Harris	2.75%
General Dynamics	2.57
Abbott Labs	2.48
Home Depot	2.45
Conoco Phillips	2.38
Top Five Underweights vs. S&P 500	Portfolio
Apple	-1.91%
General Electric	-1.62
Google	-1.51
Pfizer	-1.48
Cisco Systems	-1.39

We trimmed the portfolio's exposure to the Health Care sector by another 2% during the past quarter. Here, we sold our position in medical device maker **Medtronic**

(MDT) and drugmakers **Pfizer** (PFE) and **Mylan** (MYL). We also reduced our exposure to the **Retail** sector by liquidating or reducing several smaller holdings, including **Macy's** (M), **JC Penney** (JCP), and **Walgreen** (WAG).

Recent Transactions

As a reminder, our quantitative portfolio management process places emphasis on the construction of an entire portfolio, seeking to maintain a risk profile very similar to that of our S&P 500 benchmark. Stocks are included in the portfolio not only for their expected return, but also for their contribution to the portfolio's risk profile.

	Portfolio	S&P 500
	Weight	Weight
Consumer Discretionary	4.26%	5.27%
Consumer Staples	14.63	10.28
Energy	11.27	10.64
Financials	20.61	16.08
Health Care	9.03	11.35
Industrials	6.30	7.42
Materials	7.06	5.32
Retail	3.89	5.34
Services	3.17	5.81
Technology	17.23	18.98
Utilities	2.54	3.63

Purchases

Allegheny Technologies (ATI) manufactures and sells specialty metals worldwide. The company's High Performance Metals segment produces, converts, and distributes high performance alloys, including nickel and cobalt-based alloys and super alloys; titanium and titanium-based alloys and exotic metals. Our models rated ATI very highly, especially relative to its market cap and style group and relative to its sector peers. The market is not rewarding companies with low P/E ratios, and ATI's forecast has benefitted from that condition.

Discover Financial Services (DFS) operates as a credit card issuer and electronic payment services company primarily in the United States. The company offers Discover Card-branded credit cards to individuals and small businesses over Discover's signature card network; and other consumer products and services, including personal loans, student loans, prepaid cards, and

deposit products. DFS' strong forecast was due in large part to solid return on capital.

Equifax (EFX) collects, organizes, and manages various financial, demographic, employment, and marketing information primarily in the United States, Canada, the United Kingdom, and Brazil. The company's U.S. Consumer Information Solutions segment includes consumer information services, such as credit information and credit scoring and credit modeling services. Equifax has excellent earnings quality.

Sells

Apollo Group (APOL) provides various educational programs and services at the undergraduate, graduate, and doctoral levels. The company offers associate's, bachelor's, master's, and doctoral degree programs in arts and sciences, business and management, criminal justice and security, education, human services, health care, psychology, technology, and nursing through its campus locations and learning centers in 39 states. APOL underperformed the S&P 500 benchmark by 26% during our holding period. Despite very strong earnings quality, Apollo Group's low forecasted earnings yield is currently out of favor with investors, resulting in a weaker return forecast. We exited the position on December 15th.

Mylan (MYL) and its subsidiaries engage in the development, manufacture, marketing, licensing, and distribution of generic, brand, and branded generic pharmaceutical products and active pharmaceutical ingredients (APIs). It operates in three segments: Generics, Specialty, and Matrix. Stocks with strong intermediate-term price momentum are not being rewarded in this environment; the company also has declining earnings quality. We exited the position on December 15th; the company outperformed the S&P 500 Index by nearly 81% during our holding period.

Pfizer (PFE) engages in the discovery, development, manufacture, and marketing of prescription medicines for humans and animals worldwide. Its Pharmaceutical

segment offers Lipitor for elevated cholesterol levels in the blood; Norvasc for hypertension; Caduet for cardiovascular events; Chantix/Champix for smoking cessation; Lyrica for neuropathic pain; Geodon/Zeldox, a psychotropic agent; and Aricept for Alzheimer's disease. It also provides Celebrex for arthritis pain, and inflammation and acute pain. This was another December 15th sale, and PFE trailed the S&P 500 Index by 13.5% during our holding period. Despite strong return on capital and earnings yield, Pfizer rates poorly relative to other stocks in the Health Care sector.

Market Outlook

Bill Gross and Robert Rodriguez are two investors who merit tremendous respect. Given their respective 25+ year histories of outstanding performance in the fixed income market, I found it interesting that each wrote a similar missive to cap 2009. Each notes the reckless spending governments have made commonplace. All fiscal discipline has been tossed aside; there is no plan to balance the budget, let alone reduce debt already outstanding. To exacerbate this problem, currency printing presses ran full bore for most of late 2008 and 2009, sending our debt as a percentage of GDP higher by some 20%. This will indeed hamper long-term growth potential, and investors will have to reckon with the retraction of at least a portion of this liquidity in 2010.

Assumptions for 2010 are quite bullish, 1250 for the S&P 500 seems to be the consensus from market mavens. This presumes robust earnings growth, and a steady P/E ratio. The P/E risk is to the downside, as market P/E is inversely correlated with inflation. Corporate earnings growth must be derived from real demand, as cost-cutting and inventory rebuilding effects will fade by mid-year. 1250 on the S&P would be nice, but we believe we'll end 2010 a few percent lower than that level. We also expect the reflation trade of the past 9 months will recede, and we will again need to adapt our strategy accordingly.

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