MaxCap Value Strategy

Q4 2009 INVESTMENT UPDATE

ADVANCED INVESTMENT PARTNERS

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.

All sectors within the **Russell Top 200® Value Index** posted positive returns during 2009, paced by a 71.1% gain in the **Materials** sector. The **Technology** sector surged 59.0% on the year. The more conservative **Utilities** and **Telecom** sectors were the worst performers, albeit nothing gains of 5.8% and 6.2%, respectively.

Portfolio Review

In the 4th quarter, the portfolio's performance rebounded versus the Russell Top 200 Value Index topping index performance by 3.43%. For the year, the portfolio trailed the Russell Top 200 Value Index by a scant 0.43%. Performance was largely driven by excellent stock selection and was also lifted by varying exposure to the Energy sector and a portfolio tilt towards lower-than-average market capitalization stocks. Successful new positions in **Home Depot** (HD) and **Fedex** (FDX) outpaced the benchmark by 8.2% and 8.8%, respectively, since our purchase during the fourth quarter.

Detracting from performance were moderate overweights to the **Financial** and **Consumer Discretionary** sectors. New positions which did not meet expectations during the quarter included **BB&T Corp** (BBT) (underperforming by 3.1%), and **Occidental Petroleum** (OXY) which trailed the index by 0.7%.

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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

Portfolio Changes

We increased the portfolio's exposure to Financials, Technology, and Energy during the fourth quarter. This increased the moderate overweight in Financials and migrated the Technology and Energy sectors from small underweights to moderate overweights. In the Financial sector we initiated positions in **Capital One Financial** (COF) and **US Bancorp** (USB), and added to the holding in **Wells Fargo** (WFC). Within Technology we initiated a new position in **EMC** (EMC), and in Energy we purchased **Hess** (HES).

We trimmed the portfolio's exposure to the **Consumer Staples** sector by 2.4% and trimmed our **Health Care** allocation by 3.0%. In Consumer Staples we fully liquidated successful positions in **General Mills** (GIS) and **Reynolds American** (RAI). Within Health Care, we liquidated **Eli Lilly** (LLY) and **Bristol Myers** (BMY). Additionally, we trimmed positions in **UnitedHealth Group** (UNH) and **Pfizer** (PFE). This positions the portfolio with a moderate underweight to Consumer Staples and a benchmark weight in Health Care.

Top Active Weights - 12/31/09

Top Five Overweights vs. Russell Top 200 Value	Portfolio
News Corporation	2.63%
Aetna	2.62
Travelers	2.59
Williams Companies	2.58
Corning	2.51

Top Five Underweights vs. Russell Top 200 Value	Portfolio
Verizon	-2.44%
Goldman Sachs	-2.06
Merck	-1.77
Procter & Gamble	-1.58
Citigroup	-1.30

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 Russell Top 200 Value benchmark. Stocks are included in the portfolio not only for their expected return, but also for their contribution to the portfolio's risk profile.

Purchases

Fedex (FDX) provides transportation, e-commerce, and business services in the United States and internationally. The company was founded in 1971 and is headquartered in Memphis, Tennessee. We purchased the stock on October 27th due in large part to an increasingly attractive trading pattern.

	Portfolio Weight	Russell Top 200 Value Weight
Consumer Discretionary	9.72%	6.49%
Consumer Staples	2.40	4.80
Energy	22.19	21.31
Financials	29.13	24.70
Health Care	9.57	9.54
Industrials	6.64	8.07
Materials	1.96	4.90
Retail	6.68	2.53
Services	4.81	7.38
Technology	6.90	5.01
Utilities	0.00	5.27

Occidental Petroleum (OXY) operates as an oil and gas exploration and production company. The company has three segments: Oil and Gas; Chemical; and Midstream, Marketing, and Other. The positive forecast in OXY is earnings-based, with good projections for forecasted earnings and potential for an upside earnings surprise. We initiated the position on November 24th.

US Bancorp (USB) operates as the holding company for U.S. Bank National Association, providing various banking and financial services in the United States. U.S. Bancorp primarily serves individuals, estates, foundations, business corporations, and charitable organizations. USB had a positive outlook when we added the stock on December 15th. The company has an attractive price relative to book value and had signals of a technical reversal.

Sales

General Mills (GIS) engages in the manufacture and marketing of branded consumer foods worldwide. The company also supplies branded and unbranded food products to the foodservice and commercial baking industries. GIS was a great performer in the portfolio, outpacing the benchmark by 42.5% while we held the stock. GIS became expensive from a book value standpoint and we liquidated the position on October 13th.

Eli Lily & Co. (LLY) develops, manufactures, and sells pharmaceutical products worldwide. Eli Lilly distributes its products principally through independent wholesale distributors, as well as directly to pharmacies. LLY did not perform to expectations and lost 6.5% versus the benchmark during the holding period. We sold LLY on October 27th due to underperformance and poor earnings quality.

Reynolds American (RAI) manufactures cigarettes and other tobacco products in the United States. RAI outperformed the benchmark by 6.9% during the holding period. We liquidated the position on December 15th, as its price was high relative to book value, and the stock appeared to be overbought.

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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