

SMidCap Strategy

Q1 2010 INVESTMENT UPDATE



ADVANCED INVESTMENT PARTNERS

Market Overview

US Equities

During the first quarter of 2010, the US equity market continued the powerful rally which began on March 9, 2009. This is despite a rising chorus of naysayers proclaiming the rally to be overextended. After all, a 75% rally can't go any further, can it? We'd do well to remember the words of Sir John Templeton: "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."

As during December 2009, higher-risk stocks led the rally during the first quarter. Smaller stocks consistently outperformed larger stocks, and performance improved as one slid down the cap scale. The small cap **Russell 2000® Index** advanced 8.9% during the quarter, and has recorded a 12-month gain of nearly 63%. The **Russell Midcap 800® Index** gained 8.7% for the quarter, and the large-cap **Russell 1000® Index** added 5.7%. Finally, the generals brought up the rear - the mega-cap **Russell Top 200® Index** tacked on a still-impressive 4.6%.

Value stocks are often considered to be riskier investment plays. With investors back in risk-seeking mode, value stocks outperformed their growth counterparts across the market. The best-performing style group was small-cap value; the **Russell 2000® Value Index** leapt 10.0%. The worst-performing style group was mega-cap growth stocks; the **Russell Top 200® Growth Index** advanced 3.5% nonetheless.

Further evidence of risk seeking can be seen in the various sector returns of the **Russell 2500™ Index**. The typically more stable **Telecom** and **Utilities** sectors were the laggards, edging to gains of 0.5% and 1.1%, respectively. **Consumer Discretionary** stocks paced the market's advance, climbing 16.0%. The **Financial** sector was next-best, tacking on 12.2%.

Portfolio Review

The SMidCap strategy trailed the Russell 2500 Index by about one half of one percent during the first quarter, despite another quarter of very good stock selection driven by our models. Active performance was also helped by tilting towards high yielding stocks, and underweighting the Telecom sector. Top-performing additions to the portfolio include clothing retailer **Abercrombie & Fitch** (ANF), aerospace material maker **Titanium Metals** (TIE), and automotive equipment maker **Tenneco** (TEN). These stocks outpaced the benchmark Russell 2500 Index by 20.3%, 15.4%, and 11.6% respectively, since we initiated the holdings.

Tilting toward low P/E stocks detracted from active performance during Q1, as the market reverted to risk-seeking mode. Underweighting stocks with high volatility, and overweighting the Utility sector were variations on the same theme, and each of these exposures proved a detractor in the short-term. Each of our worst-performing additions to the portfolio was from the **Energy** sector: **Sandridge Energy** (SD), **Helmerich & Payne** (HP), and **Patterson UTI Energy** (PTEN). These positions underperformed the benchmark by 27.0%, 25.4%, and 23.2%, respectively.

Investment Team

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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 had no large changes in the portfolio's sector exposures during the quarter. We did continue to add to the Services sector, bringing us to a maximum active sector weight of 5%. We added to our position in financial data provider **Interactive Data (IDC)**, and initiated a position in mortgage and fleet management operator **PHH Corporation (PHH)**.

We trimmed our exposure to the **Retail** sector, but maintain a moderate overweight to the sector. We reduced positions in **Columbia Sportswear (COLM)** and **Tractor Supply Company (TSCO)**, while reducing our holding of **Home Shopping Network (HSNI)**. We also trimmed our exposure to the Industrial sector, a large overweight in the Consumer Discretionary sector by liquidating the position in **National Presto Industries (NPK)**, and reducing our positions in **Mohawk Industries (MHK)** and with **KBR (KBR)**.

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 2500 benchmark with a higher return potential. Stocks are included in the portfolio not only for their expected return, but also for their contribution to the portfolio's risk profile.

Top Active Weights - 3/31/10

Top Five Overweights vs. Russell 2500	Portfolio
Lexmark International	1.85%
Integrus Energy	1.81
Capella Education	1.73
Wyndham	1.60
W.R. Grace & CO	1.57
Top Five Underweights vs. Russell 2500	Portfolio
Century Tel	-0.45%
Genworth Financial	-0.37
SAIC	-0.33
Cree	-0.31
Key Corp	-0.29

Purchases

Abercrombie & Fitch (ANF) operates as a specialty retailer of casual apparel for men, women, and kids. The company sells casual sportswear apparel, including

knit and woven shirts, graphic t-shirts, fleece, jeans and woven pants, shorts, sweaters, outerwear, personal care products, and accessories under the Abercrombie & Fitch, Abercrombie kids, and Hollister brands. Our models are bullish on Abercrombie thanks in large part to the company's strong return on capital and debt coverage ratio.

Bill Barrett (BBG), an independent oil and gas company, engages in the exploration, development, and production of natural gas and crude oil principally in the Rocky Mountain region of the United States. BBG's excellent return on capital coupled with a favorable trading pattern propelled the model's bullish outlook.

PHH Corporation (PHH) provides mortgage and fleet management outsourcing services in the United States and Canada. Once again, great cash flow and a solid trading pattern proved an attractive combination.

Sales

Donaldson (DCI) engages in the manufacture and sale of filtration systems and replacement parts worldwide. The company operates in two segments, Engine Products and Industrial Products. Donaldson's cash flow generating power has slowed, and the stock's performance tailed off prior to our sale. The stock outperformed the S&P 500 by 1.8% during our holding period.

	Portfolio Weight	Russell 2500 Weight
Consumer Discretionary	14.46%	9.72%
Consumer Staples	0.63	3.56
Energy	3.92	4.69
Financials	17.09	20.08
Health Care	9.88	11.69
Industrials	6.45	9.15
Materials	6.76	7.54
Retail	7.41	6.19
Services	13.27	8.32
Technology	11.55	14.23
Utilities	8.58	4.83

Kansas City Southern (KSU) engages primarily in the freight rail transportation business. It operates north/south rail between Kansas City, Missouri, and various ports along the Gulf of Mexico in Alabama, Louisiana, Mississippi, and Texas in the midwest and southeast

regions of the United States. The company also operates direct rail passageway between Mexico City and Laredo in Texas. The stock appreciated very nicely while we held a stake, topping the index by 62.9%. The price appreciation outpaced the fundamental improvement, and we exited the position.

Comstock Resources (CRK) engages in the acquisition, development, production, and exploration of oil and natural gas properties in the United States. It has onshore operations primarily in the East Texas/North Louisiana and South Texas regions, as well as Mississippi, New Mexico, Kentucky, and the Mid-Continent regions. Here, the company's fundamentals had deteriorated during our holding period, and the company's smallish debt load is proving problematic relative to the company's earnings power. The position lagged the benchmark by 26.9% during our holding period.

Market Outlook

The bond market appears to be nearing the end of – or have already ended - a historic cyclical run. Credit spreads have collapsed from deep crisis levels to more normal levels. Treasury yields can't really go much

lower. Ten year yields appear to have bottomed – which would be a cyclical bottom. Much more important to investors should be the fact that long government bonds may have hit the end of a secular bull run as well. The massive health care package recently passed will likely only add to the government's massive debt burden. (The government's debt problem, of course, is really your, mine and our children's debt problem). While increased long-term rates correspond to an increase in the discount rate used in valuing equities, and thus acts as a damper on equity returns, the end of the bull market in Treasuries may also lead to outflows from fixed income and inflows into equities.

We believe that with volatility and credit spreads collapsing, estimated earnings growth slowing later this year, and stock correlation on the decline, we are returning to an environment more conducive to active management. Further, our models are indicating a preference to higher quality stocks (lower earnings variability, lower beta, higher dividend yield). We look forward to a steady crawl back to normalcy – even if it's "new normalcy".

Disclosure

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