

Institutional Large Cap Core Strategy

2Q10

Market Review

Quite a quarter! We have seen a shift from markets in which complacency had set in, to wide scale pessimism in three months. The stock market declined in the second quarter, with most of the major domestic indexes closing out the month of June at new lows for the year and recording the worst quarterly returns since late 2008. The broad S&P 500 Index fell almost 12% for the quarter and lost nearly 8% in the first half of the year, while the blue-chip Dow Jones Industrial Average was down almost 10% for the quarter and lost more than 6% for the year-to-date period.

The second quarter also saw a marked rise in volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX) – also known as the “fear index.” The VIX closed the month at over 34 – values above 30 are generally associated with higher levels of volatility and investor fear or uncertainty – a reading more than double the multi-year low near 15 set at the start of the quarter in April. There was no shortage of negative economic and fiscal news during the three-month period. These included concerns about the sustainability of the U.S. economic recovery and its ability to overcome a persistently high unemployment rate and a troubled housing market, the growing economic impact of the Gulf of Mexico oil spill, uncertainty about the potential impact of financial regulatory reform in the U.S., and the so-called “flash crash” of May 6th when the Dow plunged 700 points in just a few minutes.

Overseas, the sovereign debt crises of Greece and Spain, the weakening of the euro and the strengthening of the dollar, and indications of an economic slowdown in China all added to investors’ fears and helped drive them from risk-based assets into the relative safety of the fixed-income markets and gold. Indeed, Treasuries recorded the best first-half returns since 1995 and yields on 2-year Treasury notes closed the quarter near a record low.

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On the positive side, however, U.S. economic growth – while still slow at around 3% for the first half – continued to outpace most of the rest of the developed world. Job growth turned positive in the first half, and corporate earnings have shown signs of strength and given indications for continued strong growth this year. Inflation remains a non-issue while the low interest rate environment is expected to continue, supporting long-term asset growth. Finally, the combination of a slow growth environment and strong free cash flows could support an increase in merger and acquisition activity.

Portfolio Highlights

In terms of absolute returns, all 10 industry sectors in the Fund’s portfolio had negative performance for the second quarter. The greatest detractors from Fund returns came from the information technology (IT), industrials and financials sectors, while the smallest detractors were the telecommunications services, utilities and materials sectors.

Relative to the benchmark S&P 500 Index, both the Fund’s overall sector allocation and overall stock selection detracted from second quarter performance. In particular, stock selection in the health care and materials sectors was positive, but their impact was offset by the negative effect of selection in the financials, industrials, consumer discretionary and energy sectors. The only significant factor in terms of allocation was the negative impact of an underweight in the utilities sector.

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- 25 years of investment industry experience
- BA in Economics from Harvard College
- Attended Massachusetts Institute of Technology Sloan School of Management

PORTFOLIO MANAGER COMMENTARY



During the quarter, we added several new positions to the Fund's portfolio, including holdings in Cummins Inc. and 3M Co. in the industrials sector, Comerica Inc. in the financials sector, Apache Corp. in the energy sector and United States Steel Corp. in the materials sector.

The leading contributors to performance included Newmont Mining Corp. in the materials sector; Edwards Lifesciences Corp. and AmerisourceBergen Corp. in the health care sector; Apple Inc. and Dolby Laboratories Inc. in the IT sector. The bottom individual contributors to Fund performance for the second quarter included Masco Corp. in the industrials sector; Wells Fargo & Co. in the financials sector; Microsoft Corp. in the IT sector; Staples Inc. and Toll Brothers Inc. in the consumer discretionary sector.

Market Outlook

We expressed doubts in our last commentary about the ability of the economy to sustain its growth pattern as government stimulus was withdrawn. The question then moves to what happens in the financial markets as a result. Perhaps nowhere is it more apparent how the private sector has relied on government help than in housing. As the tax incentive for new buyers expires, sales have dropped precipitously, and home prices are under renewed pressure. Consumers continue to struggle, as high unemployment and accumulated debt weigh on their ability to aid in any economic upswing.

We believe we are in for a protracted period of slower-than-normal growth, as debt levels across individuals and government need to slowly unwind. The market has quickly adjusted to the idea of a renewed economic slowdown. When we look at our companies, we see many of them in the best financial shape in decades. Cash on corporate balance sheets is at levels rarely seen. Dividends have been raised, often sharply, for many. Coming out of the worst recession of our lives, we cannot help but believe that these high quality companies offer the best values in the financial spectrum. Equally important, overly rosy expectations for earnings have come down, muting the potential for disappointment down the road.

The markets always seem to find a way to surprise the most people. Almost every economist and portfolio manager (including us) was concerned about a potential rise in interest rates. Instead, with the Federal Reserve keeping short term rates at effectively zero, we also have seen a drop in 2, 5, and 10 year Treasury rates. Money from risk-averse investors and institutions has avoided stocks, and instead seems to be directed toward low-yielding government paper. The fear of inflation has given way to fears of deflation. Apparently, the Fed, by keeping short rates at zero, is also showing concern about a deflationary spiral.

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Just as the stock market seemed to be ignoring potential pitfalls in March, we believe that people are now too pessimistic on some segments of the market. Clearly, stocks have inherent risks and volatility, but sometimes, the risk-reward pendulum favors stocks. With interest rates low, it is fair to ask whether Treasuries are reflecting artificial depressants or because of weak economic demand and diminished inflationary expectations, they truly reflect a subdued economy. We think it is mostly the latter, and that is why stocks have perversely become more attractive. We can buy a variety of stocks with current dividend yields that we believe can grow over time, well above the risk-free rate of return. That is a rare occurrence, one we have not seen since the 1950s.

The past quarter was marred by two significant factors: the huge ongoing oil spill, and problems in Greece and Spain. The dislocations from both will be felt for quite awhile, but the markets have had time to factor them into prices.

PORTFOLIO MANAGER COMMENTARY



Financial “reform” is practically impossible to decipher, given the lengthy and complicated text. In our opinion, three important things NOT dealt with, are leading to increased volatility and decreased individual participation in stocks. These are the 2007 abandonment of the uptick rule on short sales, computerized high frequency trading and trading in naked credit default swaps. Investor confidence continues to erode. The stock market has compelling values, but few willing participants.

We prefer to do our investing when pessimism is high. We believe we are at a better juncture than a few months ago.

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