

Institutional Large Cap Core Strategy

4Q09

Market Review

The fourth quarter of 2009 capped off a strong year for the U.S. financial markets with a 6% increase in the S&P 500 Index. The fourth quarter rally was led by the more cyclical technology, consumer discretionary and materials sectors. The telecommunications and healthcare stocks, which had lagged earlier in the year, also performed well during the quarter. Only the financials sector, which led the market during the initial phase of the year's market rally from March through June, declined during the fourth quarter.

The fourth quarter saw modest but steady improvements in U.S. economic fundamentals. Job losses continued their decline from the January 2009 peak. In fact, December's result was encouraging enough that many economists feel that the U.S. could begin to gain jobs as early as the first quarter of 2010. The Institute for Supply Management's PMI rose in December for the fifth consecutive month, setting a new high for the year and maintaining a level that indicates the economy is expanding. Non-coal railcar loadings finally turned positive during the last two weeks of December, while housing price data released in December indicated the ninth consecutive month of improvement in 2009. December also recorded the second-best auto sales numbers for the year after the surge in August fueled by the "cash for clunkers" program. It is clear the U.S. economy is recovering from the recession.

Portfolio Highlights

In terms of absolute returns, eight out of 10 industry sectors in the Strategy's portfolio had positive performance for the fourth quarter. The greatest contributions to Strategy returns came from the information technology (IT) and health care sectors, while the financials and utilities sectors detracted from Strategy returns for the quarter.

Relative to the benchmark S&P 500 Index, the Strategy's overall stock selection contributed to fourth quarter performance while the impact of its overall sector allocation was negligible. In particular, stock selection in the IT, financials, materials and energy sectors helped relative performance for the quarter while selection in the industrials and consumer discretionary sectors hurt it.

During the quarter, we added several new positions to the Strategy's portfolio, including holdings in Hewlett-Packard Co., Kimberly-Clark Corp. and Verisk Analytics Inc. (CI A). We also closed several existing Strategy positions including Genzyme Corp. and Nokia Corp. (ADR).

The leading individual contributors to Strategy performance for the fourth quarter included Microsoft Corp., Corning

Inc., Dolby Laboratories Inc. and Apple Inc., all in the IT sector, as well as Newmont Mining Corp. in the materials sector. The bottom individual contributors to Strategy performance for the fourth quarter included Bank of America Corp. and JPMorgan Chase & Co. in the financials sector, General Electric Co. and First Solar Inc. in the industrials sector, as well as Genzyme Corp. in the health care sector (which we sold, as noted above).

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Market Outlook

The question now is “How strong will the recovery be?” We are encouraged by the breadth of improvement so far, but are concerned about headwinds ahead. The U.S. consumer remains over-leveraged, and increases in savings rates will

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slow economic growth. Projected state budget deficits are massive and prohibited by law, so state tax rates must rise and/or state spending must fall. The national budget deficit threatens to create a debt spiral unless reduced. The Federal Reserve has kept interest rates artificially low, and must ease off of its stimulus as the economy improves or risk stoking inflation. So we are confident that the recovery is here, but we believe that growth the next several years will be muted as we work off both the excesses that caused the recession and the medicine we applied to cure it.

The best opportunities in the stock market appear to us to be in the large-cap, high-quality companies that lagged the overall market last year. We have been underweight the healthcare group for many years, but have found compelling opportunities there and now hold a larger weighting than our benchmark. We see selected opportunities in cyclical stocks, with an emphasis on early cycle industrials and commodities where supply demand is snug. We like the large cap banks, but are avoiding regional banks which continue to destroy capital. In general, valuations in the market appear disperse, providing opportunities for careful stock picking.

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