

INTERNATIONAL MARKET REVIEW AND OUTLOOK

MARKET OVERVIEW

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Appetite for risky assets declined significantly in the second quarter, leading to a sharp correction in global equity prices. The MSCI EAFE Index fell 13.97% in the quarter while the US S&P 500 declined 11.43%, as investors shifted their worries to sovereign risk and slower global growth in the second half of 2010.

THE GLOBAL ECONOMY

GLOBAL SUMMARY

Although most analysts raised their expectations for 2010 global GDP growth through the first half of this year, the focus since April has been about the possibility of things going wrong with the economic recovery. Investors are again beginning to worry about the risk of a double-dip recession in the developed economies. There is a laundry list of concerns hovering over the market, including governments taking away their fiscal stimulus too soon, a Chinese economic slowdown, eurozone banking system stresses, a declining Purchasing Managers' Index (PMI) and global leading economic indicators, and growing concerns about sovereign risk contagion in Europe to name a few. Equity markets across the globe fell on rising fears and international returns were hit hardest as investors flocked to the U.S. dollar for safety – leading to significant currency weakness for most currencies relative to the U.S. dollar except the yen. Investors began to worry that fiscal tightening measures will weaken the global economic recovery at a time of much uncertainty. In China, measures to cool off the property markets and rising pressure on factory wages led to increasing fears about the country's economic growth and hit

commodity prices and stocks hard. Continued anguish over the sovereign debt of eurozone periphery countries led to sovereign ratings downgrades and significant strains in Europe's banking system.

JAPAN / ASIA

Japan's recovery peaked in the first quarter with a stellar 5% real GDP growth, while most analysts expect deceleration in the second quarter and the rest of this year. One time durable goods subsidies appear to have sugar-coated consumer spending figures in the first half and although the DPJ's flagship policy of childcare allowances finally kicks into gear in June, most expect a marked deceleration in growth. Japan's exports have benefitted from brisk expansion in Asia so far this year and comparables will become much tougher as the year progresses and into 2011. Although economic figures have begun to soften somewhat, the Japanese Yen and the equity market there have outperformed global markets as Japan is seen as a lower risk credit in the near term given its mostly domestically-funded debt amortizations and deficits.

EUROPE

The PIIGS (Portugal, Italy, Ireland, Greece, Spain) crisis that has

gripped the region and continues to garner global attention and place sustained pressure on European sovereign bond yields and credit default swaps (CDS) spreads of those countries. Europe's GDP growth continues to be maintained below 2% and the fiscal adjustments that have already passed, along with those proposed in the PIIGS countries and larger European economies risks halting Europe's economic recovery. Some analysts are beginning to project a recession in Spain with potential negative effects for the rest of Europe going into 2011.

There is continued concern about the health of the European banking sector as some banks' borrowing costs have increased significantly and as industry counterparties have become more cautious on short-term lending credit lines. This, together with Greece's fiscal and debt problems, forced the ECB & IMF to begin a more than \$700 billion backstop package to buy PIIGS debt in the secondary market. Upcoming EU bank stress tests and a large Spanish debt issuance schedule in July have markets nervous in the near-term.

The euro has taken a beating in the first half of 2010 falling 14%

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THE GLOBAL ECONOMY

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versus the U.S. dollar as markets worry about the health of Europe's financial and monetary system and the economic consequences of announced and projected fiscal tightening measures. Inflation in most developed economies is mainly contained and monetary policy mostly on hold. On a brighter note, Germany's economy is benefitting from an export surge given the weak euro and strong demand from Asia.

The new Conservative-Liberal Democrat coalition government in the U.K. has announced tough new budget cuts aimed at reducing the country's fiscal deficit from 11% to 2% over the next five years. Most effort is focused

on spending cuts but some new taxes including raising the Value Added Tax (VAT) and taxes on financial institutions are scheduled. Higher inflation than targeted keeps the Bank of England on edge and the pound has recovered some of its drop after the new budget measures were announced.

EMERGING MARKETS

Emerging economies have maintained their strong economic rebound, forcing several major central banks such as India and Brazil to begin raising interest rates on fears of rising inflation. India, China, and Brazil continue to grow at high growth rates

providing a boost to global growth prospects. China's increasing focus to rein in fast rising prices in the property market spooked markets and has led to sharp corrections in commodity markets. China is performing a balancing act as they try to shift economic growth towards domestic consumption in the long-term while weaning the economy from the fiscal stimulus measures without hurting high sustainable growth. Investors remain concerned about the near-term prospects of Central and Eastern Europe as many of those economies depend on exports to the weakening eurozone for economic growth.

POLITICAL INFLUENCES

Key political events for the quarter included elections in the U.K. and the resignation of Japan's PM with other notable elections in Germany, the Philippines, Colombia, and South Korea. In the U.K., Conservative leader David Cameron became the country's new prime minister after forming a majority coalition with the Liberal Democrats. The new coalition is focused on reining

in fiscal spending through tax increases and spending cuts. In Japan, embattled and unpopular PM Hatoyama was forced to resign after just eight months in power amid corruption scandals in his cabinet and low opinion poll numbers for him and his DPJ party. Finance Minister Naoto Kan was elected as the new prime minister and unlike his predecessor is seen as a proponent of

a weaker yen, tax increases, and greater focus on tight fiscal discipline. Germany's Merkel and South Korea's ruling Grand National Party both suffered losses in key local elections while the Philippines and Colombia both elected new presidents who won landslide victories on pro-business, anti-corruption platforms in their respective countries.

STOCK AND PORTFOLIO HIGHLIGHTS

Equity markets tumbled during the second quarter as risk aversion ruled the environment. With the euro and smaller European economies' currencies precipitous falls during the quarter, international equity returns in U.S. Dollars suffered during the quarter. As market participants shifted their attention to negative headlines and continuing data suggested developed economies around the world will see much lower growth in the second half, investors headed for the exits during the quarter. Macro events ruled the environment and investors ignored some market valuations that appeared attractive versus their history. The

sharp market selloff is creating some opportunities to buy high quality companies at attractive levels. A much anticipated rally from an ECB/IMF funding package for Greece lasted one day as markets moved on quickly to fears about the risk of contagion. Small and mid caps performed better than large caps during the quarter and year-to-date periods. Growth also fared better than value in this period. The best performing EAFE markets for the quarter were Singapore, Denmark, and Hong Kong while the worst performing markets in the quarter were Greece, Finland, and Austria. In the emerging markets, the best

performing for the quarter were Indonesia, Peru, and Colombia while the worst for the quarter were Hungary, Poland, and Russia.

OUTPERFORMERS

Sector allocation added to performance but was not enough to offset negative stock selection for the quarter. As emerging markets continued to outperform developed markets, our allocation there added to performance. Our energy holdings outperformed the sector as our focus on emerging market oil companies fared better than the sector performance overall. The portfolio's overweight

STOCK AND PORTFOLIO HIGHLIGHTS *Continued from page 2.*

and stock selection in consumer staples and health care aided performance. From a country perspective, the portfolio's overweight to Singapore and underweight to Australia helped during the quarter. When equity markets fell significantly during Q2, the portfolio's cash weight was also additive to performance.

DISAPPOINTMENTS

The portfolio was positioned well from a sector perspective during the

quarter but our stock selection was disappointing. Detrimental stock selection in the Emerging Markets as well as in the materials sector hurt our relative performance. A larger weighting to metals and mining were hit by worries about China's crack-down on property speculation amid fast rising property prices as well as potential higher than expected excise taxes on mining profits in Australia. Our exposure to Eastern Europe detracted from performance as

markets plummeted on concerns of contagion from the eurozone sovereign crisis. Our positioning in the consumer discretionary sector was off the mark during the quarter as the Japanese auto stocks, mainly exporters, were hurt by a rising yen. The industrials sector was hurt from a weighting in a Japanese trading company that has a small indirect exposure to the BP oil spill. The portfolio's exposure to some of the PIIGS countries also hurt performance as those markets fell sharply.

PURCHASES / ADDITIONS IN THE QUARTER

BNP Paribas (BNPQY): SECTOR: Financials: BNP is France's largest private bank with a key focus on corporate and investment banking and retail. The bank has strong capital ratios and is benefitting from lower provisions and a stronger pickup in revenues. Outside of France, BNP has exposure to emerging markets, western European countries and North America. Its Fortis acquisition allows the bank good synergies in the near-term.

Canon (CAJ): SECTOR: Information Technology: We added to our position in Canon as the company is seeing a good recovery in its printer and DSLR camera business. The management team is focused on a continued restructuring of the business to bring margins back to higher levels by 2015 with an emphasis on cost cutting, investing in new businesses and increasing distribution in Asia with a focus on China.

Focus Media Holdings (FMCN): SECTOR: Emerging Markets: Focus Media controls China's largest out-of-home advertising network with dominant positions in the residential and office markets. China's domestic economy is booming as its middle class rises rapidly in numbers while local and international consumer brands are focused on protecting and increasing their brand loyalty. Focus Media is benefitting from a rebounding ad market, again gaining pricing power and focusing on protecting current positions and growing its share in lower tier cities.

Fujifilm Hldgs (FUJIY): SECTOR: Information Technology: We added to our position in this leading Japanese IT company as we believe the market is under appreciating the company's turnaround and restructuring efforts. Fuji is a high quality company, trading at a good valuation offering catalysts from its turnaround and rebounding document business sales.

Nidec Corp (NJ): SECTOR: Industrials: Nidec is a leading Japanese Industrial with a dominant 80% market share of the Hard Disk Drive (HDD) spindle motor market. Demand is rebounding well for Nidec's products and the company's focus on cost savings and productivity may drive significant EPS growth over the next few years. An additional catalyst may come if electric car manufacturing takes off as Nidec may be able to capture a leading market share in electric motors.

Volvo AB (VOLVY): SECTOR: Industrials: Volvo's leading truck and construction equipment business is performing well as the market underestimated the company's cost savings and better revenue trends. The truck cycle appears to be recovering and the company is well positioned to benefit from better profitability which will increase their return on capital and lead to an upward earnings surprise cycle.

SALES / TRIMS IN THE QUARTER

Banco Santander (STD): SECTOR: Financials: We sold our position in Santander as the PIIGS sovereign crisis intensifies and as Spain suffers from perceived debt and fiscal problems. Spain appears to be the most likely country to go into a double-dip recession and while Santander's non-Spain exposure and good quality features may soothe negative effects, the bank will still feel the pressure of a declining economic environment as well as wider credit costs.

National Bank of Greece (NBG): SECTOR: Financials: We finished exiting our position in NBG as we are concerned the Greek fiscal tightening measures will keep Greece in a recessionary/slow economic environment for the foreseeable future. Sharply contracting consumer spending and business activity in the country will dampen the bank's profits for some time.

Rio Tinto (RTP): SECTOR: Materials: In a conscious effort to decrease the portfolio's exposure to the Materials sector we sold our position in Rio Tinto. China's focus on slowing down the property market will place downward pressure on commodity prices in the near-term. In addition, efforts to rein in fiscal deficits in various countries places a risk that other countries will follow on Australia's lead in increasing excise taxes on mining profits.

Sterlite Industries (SLT): SECTOR: Emerging Markets: In a conscious effort to decrease the portfolio's exposure to the Materials sector we sold our position in Sterlite. China's focus on slowing down the property market will place downward pressure on commodity prices in the near-term. The company's exposures to aluminum and zinc are less desirable as China is net long those commodities.

Tenaris (TS): SECTOR: Energy: Increasing production capacity of tubular goods in North America, concerns over economic growth in the developed world, as well as uncertainties from the drilling moratorium in the Gulf of Mexico led us to become more cautious on the energy sector and Tenaris in particular and we sold our position during the quarter.