



U.S. Equity, Large Cap Value Fourth Quarter, 2008

Market Review

A global economic crisis took hold in 4Q, marked by collapsing stock prices and frozen credit markets. As equity bear markets hit developed and developing economies, alike, extreme risk-aversion and fleeting liquidity sent high-yield spreads above 20% (source: Merrill Lynch) and temporarily pushed 3-month T-bill yields below zero in early December (source: Bloomberg). Contributing to the fear and uncertainty that fueled the market meltdown were, among other things: rising unemployment; anemic consumer spending; falling home prices; weak corporate earnings; shifting TARP policy; auto sector woes; credit downgrades of major U.S. banks; economic contraction in major economies (i.e., U.S., U.K., Euro Zone, Japan); slower growth in emerging market economies; Iceland's technical bankruptcy; rising violence in the Middle East and Southeast Asia; and a changing presidential administration in the U.S.

Seeking to lower borrowing costs and prop up the economy, the Federal Reserve cut the target fed funds rate three times in 4Q, down to a policy range of zero to 0.25%, a record low. The Fed also signaled a new policy phase in mid-December, whereby it will use its burgeoning balance sheet to support additional lending programs. Earlier in the quarter, the Fed/Treasury Department committed to using huge sums of money for initiatives that included a Commercial Paper Facility (\$1.3 trillion), Money Market Facility (\$540 billion), Asset-backed Loan Facility (\$200 billion), and GSE Purchase Program (\$600 billion). Further economic stimulus may come in the form of infrastructure spending, as suggested by the incoming Obama administration. Meanwhile, other central banks have been lowering short-term rates and implementing their own bailout packages.

In our view, the patchwork of stimulus measures has done little to heal investor confidence. Nearer-term, these measures should help spur loan growth and economic activity. However, we can't help but wonder about the longer-term implications of a much larger government debt burden. Looking at the current market environment, we believe it will take some time for a recovery to unfold. To us, the keys are housing and leverage. The current glut in housing supply (11.1 months, per the Commerce Department) and the record number of homeowners with negative mortgage equity (estimated at 1 in 6, per Moody's Economy.com) need to be worked off. This will take time, especially since none of the current stimulus initiatives targets residential mortgage borrowers directly. Similarly, we think the massive de-leveraging being undertaken by financial institutions, hedge funds and individuals will take time given the fact that this is occurring all at once.

Portfolio Review

In what amounted to a severely depressed equity market (in 4Q and the full year), our strategy outperformed its benchmark, the Russell 1000® Value Index.

Our investments in the Financial sector made the largest contribution to relative performance in 4Q, owing to our significant underweight versus the benchmark and the less credit-sensitive nature of our holdings, comprised of two property/casualty insurance companies and a processing bank. (For the

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year, Financials were a negative contributor given the performance of several troubled holdings, which were sold in 3Q.) Our investments in the Healthcare sector made the largest contribution to relative performance for the full year. We've maintained our maximum overweight in this sector for several years now, which has benefited overall performance. Our stock selection in Healthcare has been a positive contributor, as well.

The largest drag on relative performance, in 4Q and for all of 2008, came from our investments in the Energy sector. Despite the steep drop in crude oil prices from \$100/bbl to \$44/bbl in the quarter, and from \$96/bbl to \$44/bbl for the year (with a peak of \$145 reached in July), the Energy stocks in the Russell 1000® Value Index outperformed the Index, overall. Thus, our underweight allocation in Energy detracted from performance, as did our stock selection in this sector, for both the quarter and year.

5 Largest Contributors*	Sector	5 Largest Detractors*	Sector
Archer Daniels Midland Co.	Consumer Staples	R.R. Donnelley & Sons Co.	Industrials
Travelers Cos. Inc.	Financials	Limited Brands Inc.	Consumer Discretionary
Bristol-Myers Squibb Co.	Healthcare	E.I. DuPont de Nemours & Co.	Materials
Waste Management Inc.	Industrials	Hartford Financial Services Group Inc.	Financials
Verizon Communications Inc.	Telecommunication Services	Motorola Inc.	Information Technology

Transactions

During the 4th quarter, we sold two holdings (both in the Financial sector) and purchased four (two Financial stocks, one Consumer Staples stock and one Healthcare stock). At quarter end, there were 32 stocks in the portfolio. We expect to add a 33rd position in the coming months.

Sales

Hartford Financial Services (HIG) – Hartford was experiencing growth challenges, particularly in its life insurance business. Unraveling credit/equity markets were applying additional pressure. Hartford's capital cushion had weakened. We were growing increasingly concerned about the company's life insurance operation owing to equity-related exposures and corresponding product guarantees. Additionally, Hartford's life subsidiary investment portfolio contained higher-risk securities, notably CMBS, which were being viewed more negatively by investors. During the week prior to sale, Hartford was downgraded by two rating agencies. We felt there was heightened risk of a dilutive capital raise and/or further credit rating agency downgrades, which might cause another negative feedback loop to develop (i.e., widening spreads—falling stock price—new rating agency threats), similar to the experience of other stressed financials during the credit meltdown. We sold Hartford in October.

Discover Financial Services (DFS) – In 2008, through our October sale date, Discover's share price had held up better than the financial sector and the broad market by a considerable amount. Economic and financial market conditions were deteriorating beyond our expectations. Negative trends in housing, unemployment and credit were creating a much more challenging consumer spending environment. Delinquency and charge-off rates were increasing. Given our view that serious economic challenges could persist for some time, we believed Discover's earnings would come under increasing pressure. Furthermore, the funding environment was becoming more difficult, with securitization markets all but inactive. The severity of the credit crisis led us to reposition our exposure in financials; we were looking to own companies with diverse business mixes, stronger balance sheets and easier access to capital. Discover did not fit these criteria.

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Purchases

Travelers Corp. (TRV) – Travelers is a diversified property/casualty insurance company and the 2nd largest underwriter of commercial and personal insurance in the U.S. Given recent pressure on financial companies and softness in insurance pricing, Travelers' valuation had become very attractive; the stock's price-to-earnings and price-to-book multiples were at the low end of their long-term ranges, and the dividend yield was at the high end of its range. The stock scored in the cheapest decile in our opportunity screen. Travelers had a relatively strong balance sheet and an investment portfolio with above-average quality, in our opinion. It was also well-positioned to benefit from problems at competitors such as AIG. With the team rebuilding its financial sector exposure, and credit and equity markets coming under increasing stress, Travelers was viewed as an attractive purchase given its minimal exposure to low-grade credits and leverage. A 3% target weight position was purchased in October.

CVS Caremark (CVS) – is the largest provider of prescriptions and related health care services in the U.S. through its retail pharmacies and pharmacy benefit manager (PBM). Prior to purchase, CVS sold off due to concerns about its exposure to a recessionary consumer spending environment and the broader downturn in the equity market. By October 2008, CVS was trading at a substantial discount to long-term (20-year) price multiples relative to cash flow, earnings and sales. It scored in the 4th cheapest decile in our opportunity screen. CVS's competitive positioning is attractive—only 15% of business is derived from discretionary spending (industry average is 25%) and 80% of revenue is attributable to its pharmacy business. It has a higher content of private label goods in its stores, which should benefit from consumers trading down in a faltering economy. CVS also stands to benefit from increased generic drug usage since this is a key driver of PBM profitability. This purchase, completed in October, increased the portfolio's exposure to both consumer staples and healthcare spending.

Cardinal Health (CAH) – is a major healthcare products distribution company, as well as a manufacturer of clinical and medical products. Cardinal is the #2 player in a concentrated, consolidating industry (the top three companies represent 96% of the distribution market). The stock had underperformed over the past year due to a series of earnings misses, concern surrounding the renewal of its contract with CVS, and management's delay in providing long-term guidance. Valuation had become attractive—Cardinal was the cheapest of the 3 major distributors, was trading well below longer term multiples of earnings, book value, cash flow, and was scoring in the 2nd cheapest decile in our opportunity screen. Distributors earn higher margins on generic drugs, which meant Cardinal offered an attractive way to offset some of the patent expiration risk inherent in several pharmaceutical companies in the portfolio. The addition of a 3% position in Cardinal, in early November, helped diversify the portfolio's healthcare exposure and raised the healthcare sector target weight to 21%.

Bank of New York Mellon (BK) – is a commercial bank that generates most of its revenue from fee-based and processing-oriented sources. It commands sizable market share in a variety of businesses. Processing banks tend to be less capital intensive than traditional/investment banks, a positive in our view given the tight credit market. Barriers to entry are high and scale is important to both growth and profitability. BK was attractively valued at time of purchase. The stock was trading at 1.2x book value versus a longer-term average of 2.3x. It scored in the 3rd cheapest decile in our opportunity screen. While BK's fee-based revenues would be under pressure in the shaky economic environment, we believed it offered a more attractive way to invest in Financials given its less credit-sensitive businesses and more predictable earnings. Also, BK had a far smaller proportion of potentially troubled assets than its commercial banking counterparts. A 3% target weight position was purchased in November, raising the portfolio's target allocation in Financials to 9%.

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Outlook

This past year was extremely difficult for investors in most asset classes. For equity investors, 2008 was the worst year for returns since the 1930s. The collapse of the credit and housing bubbles dealt a serious blow to the financial system and continues to put significant pressure on the broader economy. As a team, we had our own challenges navigating the market meltdown. In the early stages, we were inclined to add to depressed holdings as their prices continued to fall. During spring/summer of 2008, we kept these stocks on hold, not adding to them as we looked for signs of recovery. By early fall, as the severity of the crisis intensified, we moved to build additional defensiveness into the portfolio and exited stocks that appeared riskier from a credit quality perspective.

In our view, the financial system remains fragile. We expect more pressure on corporate earnings and continued economic weakness. The market lows reached in November 2008 could be re-tested in 2009. Nonetheless, market valuation levels are starting to look compelling—a development we are very enthusiastic about. The trailing price-to-earnings ratio for the S&P 500 Index, based on 5-year normalized earnings, is approximately 12x (source: Leuthold Group); and, based on 10-year normalized earnings, the price-to-earnings ratio is below its long-term average for the first time since the late 1980s (source: Robert Shiller). Consequently, the long-term return potential for the stock market is looking more attractive to us. Because of negative trends in housing and consumer spending, and ongoing de-leveraging across the financial system, we want to stay defensively positioned in the near term. We're maintaining overweight allocations in Consumer Staples, Healthcare, and Telecommunications Services (the portfolio's combined target weight for these sectors is currently 45%). We're looking at potential investments in cyclical areas such as Energy and Industrials, believing further declines in earnings expectations will give us more attractive entry points for stocks in these sectors. We intend to remain patient and, as usual, emphasize compelling valuation and relative financial strength when assessing new investment ideas.

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