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ASSET MANAGEMENT



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The Boston Company Asset Management (TBCAM), based in Boston, uses a bottom-up approach to stock selection, blending quantitative screening with fundamental research. The manager covers value, growth, core, and market neutral strategies.

THE BOSTON COMPANY

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The US economy wakes from its slumber

This year has seen a dramatic turnaround in the US economy. Since his inauguration in January, President Obama has attempted to blunt the impact of the recession by agreeing to an US\$800 billion economic stimulus package, introducing a sizable mortgage relief programme and joining private investors to purchase toxic bank assets. Other stimulus packages were enacted globally, representing an unprecedented commitment from governments to stabilise the world's economies.

By mid-year, there were encouraging signs that the economy had begun to turn the corner from recession to recovery. Growing confidence in policy stimulus and less devastating economic news led to an unprecedented recovery in global equities. In fact, the global equity market rally that began in early March and continued into May was one of the strongest rebounds since the Great Depression era, with much of the rally centering on higher beta stocks with operational or financial leverage. A number of key economic indicators either stabilised or improved – at least in the short term – after having experienced significant declines over the previous few quarters. For instance, American consumer confidence surged in May, representing the biggest monthly increase since 2003.

The sharp equity market rally that began in March lost a bit of steam as equity

markets, developed and emerging alike, pulled back modestly in June as investors trod cautiously out of fear that the equity markets had moved too far ahead of economic reality. The World Bank further dampened investor enthusiasm by reporting that prospects for the global economy remain “unusually uncertain” and reducing its 2009 and 2010 growth forecasts for most economies, including the US, Japan and the Eurozone.

Green shoots start to take root

However, towards the end of the year, stronger-than-expected corporate earnings, combined with encouraging economic news, further drove global equity indices to levels unseen since late 2008. Positive earnings surprises in the US, Europe and Japan exceeded negative earnings surprises, providing a nice complement to robust economic figures emanating from China in recent months and signs of improving conditions elsewhere. While most of the earnings upside at the company level continues to come from cost-cutting versus top-line sales growth, this has tended to be the typical trend as recessions bottom out.

On the economic front, the US economy expanded at an annualised rate of 3.5% in the third quarter, as massive government stimulus helped pull the economy out of its longest recession since the 1930s. Despite the abundance of positive news, markets

have continued to struggle with the ongoing negative effects of rising unemployment (which hit double figures in October), a tight credit environment, and weakness in commercial real estate, among other issues. This pattern of positive developments, tempered with set backs, is typical of economic recoveries and merely reflects the fact that different types of economic activity require more time and/or divergent remedies to get back on track. Moreover, the unprecedented global efforts taken to prevent an economic meltdown have just begun to produce positive results; much of their benefits have yet to be realised, and funds remain in the pipeline that will not make their way into the system until 2010.

Banking on caution

Overall, we have observed a notable change in confidence, as recently as the third quarter, emanating out of corporate America through our ongoing discussions with CEOs and CFOs who appear decidedly more optimistic and upbeat about their business prospects. This trend is a necessary and important pre-cursor to increased capital spending, which,

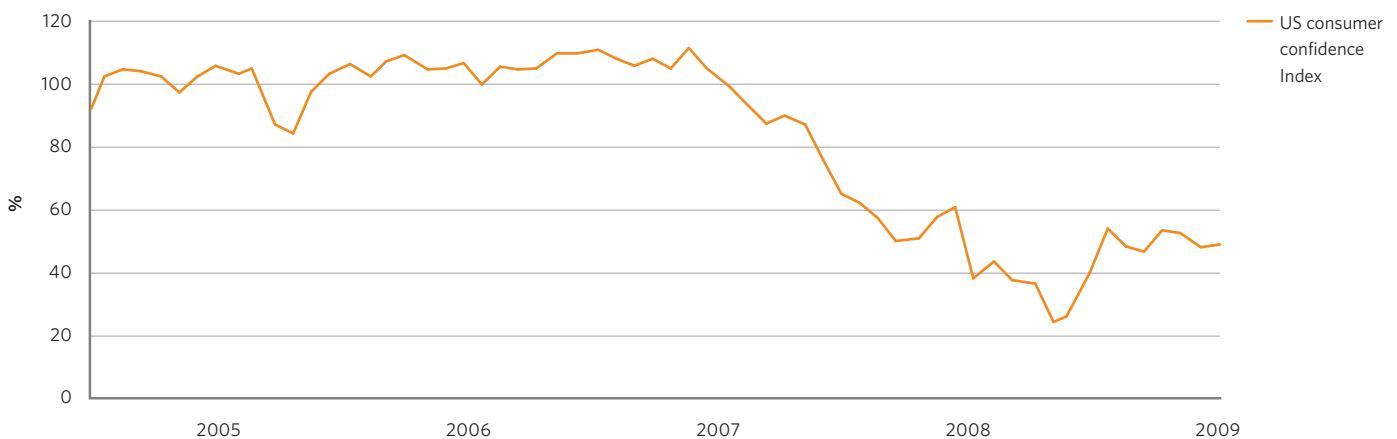
in turn, should lead to improvement in employment (a lagging indicator). Amid this economic backdrop and despite the significant rise in stock prices, we anticipate a disproportionately large number of companies to beat expectations and give favourable guidance during third quarter earnings season. The information technology sector in particular continues to offer attractive opportunities, especially in those companies exposed to the improving environment for enterprise spend and the year-end budget flush.

Meanwhile, the consumer discretionary sector looks attractive given improvements in sales trends, easy comparisons, and attractive valuations based on earnings potential. However, we maintain a cautious stance on financials, given our concerns about commercial real estate conditions affecting regional banks and other highly exposed financials firms in particular. That said, we are finding attractive opportunities within financial companies exposed to improving capital markets, mortgage businesses and consumer credit.

Long road to recovery

The rally seen thus far in US equity markets has been driven by stabilisation. Corporate earnings beat reduced expectations, largely through cost cuts, while house price declines have shown signs of slowing. However, rallying around the first signs of economic stabilisation does not change the fact that consumers remain hobbled by debt, unemployment has reached a multi-decade high, and house prices remain depressed. After big gains, especially in riskier assets, investors will have to question the underlying strength of those companies and whether or not their earnings growth and financial strength has warranted the surge in their stock prices. In addition to stabilisation, liquidity has been a major contributor to market strength. There is uncertainty about what will drive markets going forward as the Federal Reserve (Fed) starts to reverse and unwind its unprecedented levels of support provided to the economy. As the Fed's plans become clearer, we may see a shift in market leadership from more speculative companies to those with higher earnings and balance sheet quality.

STABILISING US CONSUMER CONFIDENCE



Source: Datastream as at 25 November 2009

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