US Large Cap Growth Equity Portfolio

1st Quarter 2008 Commentary

Portfolio Review

In the 1st quarter of 2008, the SGA composite returned –4.77%, comfortably outperforming the –10.18% return of the Russell 1000 Growth Index and the –9.44% of the S&P 500. The average return of the Morningstar Large Growth category was –11.67% and -11.22% for Lipper's.

The Scarcity of Growth

The first three months of the year were exceedingly difficult for the stock market, as evidenced by the declines of 9–10% in the broad stock indexes. There was no evidence of a bottom in the deteriorating housing market, and continued mortgage woes led to a marked increase in foreclosures. The aftershocks from the subprime lending meltdown are still reverberating throughout the financial sector, most notably as a credit crunch that has dramatically curtailed liquidity and nearly resulted in the bankruptcy of investment bank Bear Stearns. And despite the Federal Reserve's aggressive efforts to prop up the economy and financial system, the risk of a recession increased considerably during the quarter as job growth slowed sharply and retail sales figures revealed a pullback in consumer spending.

Most importantly, U.S. corporate profit growth continued its trend of deceleration during the quarter. Although much of the decline was concentrated in the financial sector, we are beginning to see signs of weakness in several other segments of the economy (energy being a noteworthy exception). Currently, corporate earnings growth is expected to be 8-9% in 2008, but given the challenges facing the economy and the upheaval in the financial system, we wouldn't be surprised to see those expectations come down sharply as the year goes on. By comparison, we expect the earnings growth of the companies held in the portfolio to remain in the 13%-15% range.

This kind of environment, where growth becomes increasingly scarce, tends to be very favorable for the companies that comprise the SGA portfolio, and our performance in the first quarter of 2008 reflected this developing trend. In fact, over the last three quarters, this approach has clearly demonstrated its ability to preserve capital in more challenging times: SGA–0.63%, Russell 1000 Growth Index–7.12% and S&P 500 Index–10.68%

The market has begun to value and reward high-quality businesses that generate consistent, sustainable double-digit earnings growth regardless of the economic environment.

It is important to note that the underpinning of this shift in sentiment and the element that gives us increased confidence in the continuation of the recent outperformance is the fact that portfolio companies are delivering the numbers as expected. In 2007, the aggregate earnings of the companies in the portfolio grew by approximately 15%, right in line with our expectations. In contrast, the aggregate earnings of the companies in the S&P 500 *declined* by 2% last year. As these figures make clear, growth is becoming scarce in the broader market but ample in the SGA portfolio, and investors are beginning to take notice. It should be noted that in the past, these periods lasted for multiple years and we could be at the beginning of another strong period for this approach.

Every sector in the market declined in the first quarter of 2008, but consumer staples and materials stocks held up the best. The financial & information technology sectors suffered steep losses, which created some attractive investment opportunities for us in these areas of the market.

The Winners' Circle

Nearly 3/4 of the stocks in the portfolio added value to relative performance during the quarter. The leading contributor was electronics maker **Apple**, which was a new addition to the portfolio during the quarter. Apple is an outstanding, innovative global brand with a maturing iPod franchise, a rapidly expanding iPhone franchise, and an iMac franchise poised for robust growth. The stock price tumbled by more than 40% early in the quarter after the company tempered earnings expectations for 2008, so we were able to initiate a position in the stock at a very attractive valuation, and it has subsequently rebounded.

Package delivery company **FedEx** was another top contributor. The company is well positioned long-term to participate in the growth of global commerce and investors took some comfort in the quarter from trucking volume data, a leading indicator of economic activity, which showed some stabilization after months of decline.

Another favorable performer was wireless technology company **Qualcomm**. The gradual global transition to 3G wireless technology continues to gain momentum, and QCOM earns royalties on its 3G patents for every wireless device produced with this technology. In addition, there is some evidence that the legal dispute with Nokia could be resolved by the end of 2008.

The Also-Rans

Among the handful of individual detractors, software giant **Microsoft** had one of the biggest negative impact on relative results. The company reported very strong earnings during the quarter, providing further evidence that Microsoft continues to benefit from a healthy new product cycle. However, Microsoft's unsolicited bid to acquire Yahoo! was an overhang for the stock price as the size of the bid—and the uncertainty —dismayed investors.

Natural foods retailer **Whole Foods** was another notable detractor. Although comparable store sales growth improved significantly, the challenge of integrating the acquisition of competitor Wild Oats Markets has hurt profit margins. We reduced our position during the quarter.

Insurance broker **AIG** was unable to extricate itself from the credit troubles affecting the overall financial sector. AIG has taken significant write-downs on mortgage-related assets, is experiencing growing difficulty in some of its core franchises and there is considerably less earnings visibility for the company going forward. The stock was already a small, underweight position when the quarter began, and we chose to eliminate AIG entirely.

Portfolio Changes

Portfolio turnover was higher than normal in the first quarter, which was indicative of the wealth of opportunities that presented themselves during the sharp market decline. We took advantage of the opportunity to add four new positions to the portfolio—two each from the beaten-down technology and financial sectors.

As mentioned previously, we added Apple to the portfolio after its stock price fell dramatically early in the quarter. We also initiated a position in online advertising giant **Google**, which suffered a substantial decline of its own, creating an attractive entry point. Google is the dominant internet advertising company with an innovative business model, a superior management team, and an enormous competitive advantage in its search algorithm and brand awareness. The opportunity was especially attractive given the approval of their acquisition of Double-Click which will further solidify their leadership position with online advertisers. Incidentally Microsoft's bid for Yahoo! was validation of the importance of this market segment and indicative of the insurmountable lead that Google has established.

In the financial sector, we added two credit card companies—**American Express** and **Visa**. AmEx operates one of the premier global payment networks in the credit card industry, and its cardholders have higher income and charge four times more on their AmEx cards than other credit cards. Visa, which went public in mid-March, was the first IPO in which we have ever participated. Visa operates the world's largest electronic payment network & has more credit and debit cards, does more transactions and a greater total dollar volume than any other card company. It is different from AmEx in that its customers are not the cardholders but rather the thousands of financial institutions that issue Visa cards and therefore the company has no credit risk. To make room for these new additions, we eliminated three long-time portfolio holdings. We sold consumer products maker **Colgate-Palmolive**, medical products maker **Stryker**, and AIG (as previously described). Both Colgate and Stryker were sold in large part because the stocks had appreciated meaningfully in the past few years resulting in relatively high valuations.

Outlook & Strategy

We are encouraged by the continuing shift in the market's perception toward sustainable growth companies. After several years of patiently sticking to our discipline while the market chased high-flying but unsustainable growth stocks, we are gratified to see our investment approach come back. We are also enthusiastic about the opportunities on which we have been able to capitalize during the recent market downturn. We believe the portfolio is well positioned going forward, with an exciting mix of quality growth businesses. In addition, the valuations of portfolio companies remain compelling despite their recent outperformance. Compared with past instances when our investment strategy began a period of outperformance, current valuations are starting from a much lower base, which bodes well for the potential longevity of the recovery in high quality growth stocks as the market once again assigns premium valuations to companies with consistent double-digit earnings growth.

Market trends typically do not turn on a dime and tend to overshoot, both on the upside and the downside. The above-average corporate profit growth cycle lasted far longer than we anticipated. We would not be surprised if this current trend lasted longer than many currently expect.

Despite the generally positive environment for our investment approach, we remain cautiously optimistic going forward. We were pleased with the portfolio's relative performance in the 1st quarter, but we do not expect this magnitude of outperformance to repeat itself consistently. However, we believe the stage is set for the portfolio to continue generating favorable results for some time to come.

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