

# Small- and Mid-Cap Core

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## Fourth Quarter 2006 Investment Update

U.S. equity markets finished a strong year with a strong fourth quarter. Any cause for investor concern was pushed aside as the market closed 2006 near its all time high. Investors embraced the soft landing scenario for the economy and the belief that the Fed would be cutting rates in the first half of 2007 which would be good for equities. This view combined with almost daily news of another merger or acquisition put a floor under stocks and created conditions which encouraged investors to increase their risk exposure into year end. This backdrop, once again, proved to be a difficult environment for active managers to beat their bench marks. We are pleased to report we did.

Fourth quarter 2006 was unusual and atypical. Even the annual doom and gloom that normally weakens markets early in the quarter never materialized. Both the Russell 2000 and the Russell Midcap came charging out of the gate with strong gains in October and November before moving sideways in December. For the entire fourth quarter, the Russell 2000 was up 8.9%, the Russell Midcap appreciated 7.7% and both outperformed the S&P 500 which was up 6.7%. For the year, the Russell 2000 was up 18.4% compared to 15.8% for the S&P 500 while the Russell Midcap appreciated 15.3%. Within the Russell 2000, value outperformed growth both for the quarter (9.0% compared to 8.8%) and the year (23.5% versus 13.4%).

**Small Cap Core:** During 4Q06, all of the Russell 2000 sectors had positive returns: consumer staples up 14.4%, materials & processing which increased 12.4%, auto & transportation which rose 10.8% and consumer discretionary which appreciated 10.2% led the way. The laggards were financial services which rose 6.3% and health care which was up 8.0%.

Our 4Q outperformance was driven by stock selection. Our stock picks in health care, financials, industrials and materials all contributed positively relative to the Russell 2000. Most of the underperformance relative to the benchmark occurred in our consumer discretionary stocks.

**Mid Cap Core:** All of the Russell Midcap index sectors also had positive returns for the fourth quarter: Materials & processing which was up 13.5%, REITs increased 10.7% and consumer discretionary which appreciated 8.7% led the way. The laggards were consumer staples which rose just 0.6% and health care which was up 3.0%.

Our 4Q outperformance was driven by stock selection. Our stock picks in technology, health care and consumer staples all contributed positively relative to the Russell Midcap. Underperformance relative to the benchmark occurred in consumer discretionary and energy.

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We believe that both portfolios are invested in attractively valued stocks that each have a catalyst or catalysts over the near to intermediate term and a good management team that will bring these catalysts to bear. We were pleased to see some of these values recognized in the fourth quarter. We enter 2007 focused on continuing this process of finding the best investment opportunities. We are confident that this can be done no matter what the macro backdrop holds as the year unfolds.