

Review of Second Quarter 2010

Market Commentary

The business cycle has continued to proceed with the impact from the inventory cycle and federal stimulus fading, and private sector employment and spending continuing to improve. This transition has resulted in a decline in the overall economic growth rate globally. Unfortunately, this business cycle transition is occurring as further pressure developed in the European banking sector and sovereign debt markets, and risk assets have corrected significantly as investors discount slower future growth. This has been reflected in equity markets for the quarter.

At the country level, the US market was down almost 7%. Europe was generally down as the market fretted about the euro. Finland, Switzerland and Sweden, all down 3% to flat, were the most resilient; this was in contrast to battered Greece, down 33% and Norway and Spain, which were both down around 20%. The disparity in performance in Asia was less marked with Singapore, the Republic of Korea and Hong Kong all in positive territory up 2% to 8%, whilst Japan suffered a moderate fall of close to 2%.

Performance

For the quarter, the Apostle Global Small Mid Cap Fund was down -2.0% with the S&P Developed Ex-Australia US\$2 - \$10 Billion Index falling similarly by -1.9%.

At the sector level in the EAFE component, defensives such as Consumer Staples, Telecommunications and Utilities were strongest whilst Energy, Banks and Materials saw the biggest falls. In the US, all sectors except Telecommunications declined for the quarter, with the more cyclical sectors leading the market down on economic growth concerns. Sectors less vulnerable to a potential economic slowdown such as Health Care and Staples declined less. Detracting the most from performance was the Financial sector, led by weakness in the capital markets stocks.

Portfolio Positioning

With valuations balanced across the various sectors and the potential for deflation pressures to increase prior to an increase in inflation expectations, the Managers continue to position the portfolio into companies that have better pricing power, lower earnings variability, higher profitability and stronger balance sheets than the broader investment universe. They still do not favour any single industry sector, and continue to look for the characteristics noted above across all industries. Should the economy continue to slow dramatically they would expect these companies to become stronger by leveraging their business models to gain market share. In addition, many of these companies should experience higher earnings growth than the broader universe as market share gains and margin protection are translated into stronger earnings per share than many of their competitors.

During the quarter, the US Managers reduced their cyclical exposure in light of the uncertainties discussed above. They reduced or eliminated positions in companies most dependent on accelerating economic growth, and reinvested the proceeds in companies that are capable of growing earnings in a more sluggish economic environment. For example, department store retailer Macy's and

consumer electronics retailer Best Buy were sold, and proceeds reinvested in companies including J. M. Smucker (jams and jellies, peanut butter, and other food products) and Kroger (supermarket retailer) whose sales are less dependent on economic growth. They initiated positions in several electric utilities for the first time in many months, as they identified companies such as American Electric Power (Midwest and southern U.S. markets), PG&E Corporation (northern and central California), and Wisconsin Energy (Wisconsin and Michigan) that are winding down capital expenditure programs and receiving rate relief on new projects that should enhance cash flow and dividend growth going forward.

Outside of the US, the Managers initiated new positions in a number of names: St. Micro Electronics, the Dutch semiconductor company, this is a restructuring play moving back to its core competence in industrial and automotive chips where it is a world leader. Kerry Group, the Irish global leader in food ingredients and UBI Banca, a very solid regional bank in Italy, where banks have been uniformly punished in the panic regarding Italian government bonds. Finmeccanica, another Italian name, is a very strong player globally in helicopters and defence electronics, Hisamitsu Pharmaceutical, the dominant player in topical painkillers, is expanding rapidly internationally, KLCC Property, a Malaysian real estate company with minimal leverage, held firm as the market collapsed. This is a new name in the portfolio, defensively positioned, KLCC owns premium assets such as the Petronas twin towers and the adjoining shipping mall and hotel. International Power is a UK-based power generation company with a diversified asset base, owns electricity generating plants worldwide. Profits were taken in ARM, S1 and Assa Abloy.

Outlook

As we enter the second half of 2010, global equity markets remain concerned about the continued side-effects of the deflating credit balloon which peaked three years ago and continues to come down. Despite best efforts of major governments to support faith in the financial markets, and the banks in particular, the consumers and corporates of the west remain risk averse, and banks have made it expensive and difficult to gain access to credit. The attention of the investment community has turned from the banking sector to the balance sheet of weaker economies in the periphery of Europe and to states and municipalities in the larger countries, such as the US and China. A reduction in central and local government debt, higher taxes and higher unemployment seem unavoidable. The next wave of concern is likely to focus on the aftermath of the massive infrastructure boom in China, and how the local governments are going to pay for it.

Generally, equity markets will continue to be volatile until economic data and corporate earnings reveal whether this is a double-dip recession or a mid-cycle slowdown. The managers expect the economy to continue to grow, but at a slow and "choppy" pace. One silver lining is that as credit recedes, asset price inflation is likely to cool markedly, improving the cost of living for most consumers. The other major positive is that most of these fears are now being reflected in the valuations of those stocks most vulnerable to a downturn.