

LARGE-CAP CORE EQUITY

MARKETS ADJUSTING TO MODERATE GROWTH

Differentiated Performance by Sector and Region Will Continue

The third quarter was a difficult period for equity investors as stock prices fell worldwide. The moderate pace of economic growth in the U.S. disappointed some investors, and developments abroad compounded anxiety about U.S. economic growth. Worries about a European-led financial crisis contributed to some of last quarter's sharpest market declines, while signals of slower growth in China weighed on stock prices later in the quarter. Concerns about slower growth, however, did not impact all stock markets or Sectors of the U.S. stock market uniformly.

The Dollar and Global Events Shaped the Market Backdrop

The start of the third quarter marked the end of the Federal Reserve's \$600 billion dollar bond purchase program commonly known as QE2. Prospects for further liquidity injections from the Fed looked limited during the third quarter as higher commodity prices boosted headline inflation, and core inflation reached the Fed's unofficial 2% per annum target. The value of the dollar appreciated compared to other currencies after QE2 ended and as investors discounted only a small chance of another round of quantitative easing. A stronger economic growth outlook in the U.S. compared to apparently anemic growth in other developed economies also boosted the value of the dollar in the third quarter.

The value of the dollar, as we emphasized in last quarter's commentary, is a key driver of commodity prices. The increase in the dollar in the third quarter drove declines in commodity markets and underpinned the moves of global stock markets. Chart 1 illustrates that commodities fell broadly with sharp declines in copper, cotton, oil and wheat. Slower projected growth in China also contributed to recent commodity price weakness.

Europe's sovereign debt troubles not only contributed to the recent strength of the dollar, but also helped set the tone for financial markets in the third quarter. We believe, as we have said before, that there is a low probability that the debt problems in Europe will undermine the global financial system. Our view, instead, is that the member states of the European Union (EU), led by Germany and France, will eventually address Europe's sovereign debt difficulties in some manner. But even with a successful resolution to these difficulties, the EU will still face the challenge of slower economic growth. We believe that this weaker growth in the EU will affect Europe primarily and have only a limited impact on economic growth in the U.S.

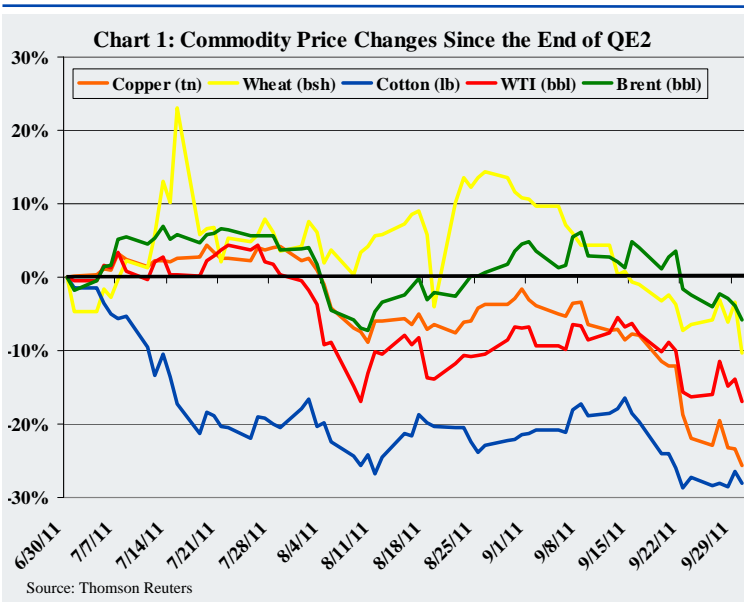
Stock markets reacted differently to the European debt concerns just as the decline in commodity prices did not affect all markets

equally. The German, French and Italian stock markets fell 31%, 30% and 32%, respectively during the third quarter, while the U.S. and U.K. stock markets declined 14% and 16%, respectively.

U.S. Economic Fundamentals are Crucial

Concerns about slower growth abroad, nevertheless, fed worries about the prospect of a recession in the U.S. Growth in Asia and Europe certainly influence the U.S. economy, but overseas growth does not determine U.S. growth. Our investment process at WestEnd keeps us focused on a broad set of U.S. data, while also tracking the health of other key economies. And we believe this U.S.-focused approach is the best method to evaluate the outlook for the U.S. economy and build timely portfolios.

The Bureau of Economic Analysis released second quarter GDP data late in July, along with revisions to GDP data dating back nearly five years. This information showed that recent economic growth was weaker than previously thought and reignited U.S. recession fears. First quarter 2011 GDP growth was revised down from the previous estimate of a 2.1% annualized increase to a 0.4% increase. We were encouraged to find, however, that the contribution to growth from consumer spending and from business capex remained the major drivers of growth in the first quarter. These positive contributors to growth, however, were offset by larger than previously calculated drags from international trade and inventories



- two volatile categories of data that can swing significantly from one quarter to the next.

Second quarter GDP growth also concerned investors, especially as the pace of consumer spending did slow. This spending data, however, reflected the impact of the Japanese earthquake and tsunami. The March disasters severely affected auto parts manufacturing in Japan, and in turn, led to supply disruptions globally that slowed production and prevented deliveries to dealers in the U.S. Car purchases slumped in the second quarter, in large part from these supply difficulties, and car sales detracted 0.7 percentage point from GDP growth in the second quarter. GDP would have increased at a 2.0% annual rate had it not been for the negative impact of auto sales, and consumer spending would have been the largest contributor to GDP growth. This adjustment for auto sales is warranted in our view as spending on other durable goods continued to grow in the second quarter. In addition, car sales picked up significantly in July as supply difficulties ebbed. Car sales as of September had returned to a pre-earthquake annualized pace of over 13 million units.

An examination of these clouded economic readings from the first half of the year shows that economic conditions were stronger than the headline data indicated. But even after the adjustment for lower car sales, investors remained concerned that real (or inflation-adjusted) spending had moderated. This again was not the full story. Nominal consumer spending continued to grow at a strong pace this year, even as the pace of real consumer spending growth slowed in recent quarters - in part from temporary QE2-boosted inflation. Chart 2 highlights nominal consumer spending that grew at a 4% annual rate in the first half of 2011, which is consistent with pre-recession nominal growth rates, even as real spending growth slowed in the second quarter. Businesses, of course, operate in a nominal environment, so financial results are reported in nominal terms. This helps explain how well-run, consumer-oriented companies that can control costs and raise prices were able to deliver strong sales and earnings growth in the first half of 2011, despite the slower inflation-adjusted GDP growth.

Third quarter economic data released thus far points to a modest pickup in economic growth. Consumer spending growth was solid through August, and early indications for September - like chain store sales and auto sales - point to strength last month as well. The pace of business capex growth accelerated in the third quarter to the fastest pace in over a year, while exports reached a new all-time high. Not all indicators were this strong, however, but even the ISM purchasing managers surveys, which were lower in the third quarter compared to earlier in the year, continued to signal growth. And while companies have not picked up the pace of hiring since the beginning of the year, companies have not increased layoffs either, which should keep workers' sense of job security high.

The Most Economically Sensitive Sectors Hit the Hardest

We believe that the U.S. economic data from the third quarter indicates the U.S. economy is on a path of moderate growth. Some bearish investors believe that growth will not even be that robust. Other more bullish investors hold out hope for a reacceleration in growth. But there is no doubt that the consensus outlook for growth in 2011 is nowhere near the 4% GDP growth that was expected at the beginning of this year. The shift down in expectations, which occurred largely last quarter, has impacted stock prices. As we have emphasized previously, however, these types of shifts do not impact all parts of the stock market uniformly.

A reduced outlook for U.S. growth, as expected, hit the most economically sensitive Sectors the hardest as the earnings of companies in these Sectors are most vulnerable to a slowdown in growth. Plus, the outlook for weaker growth outside the U.S. and the strength in the dollar further exacerbated the pressure on commodity-oriented businesses. The Materials, Financials, Energy and Industrials Sectors were all down 20.46% or more in the third quarter. Chart 3 demonstrates that the six other market Sectors were down less than the 13.87% decline in the S&P 500 Index.

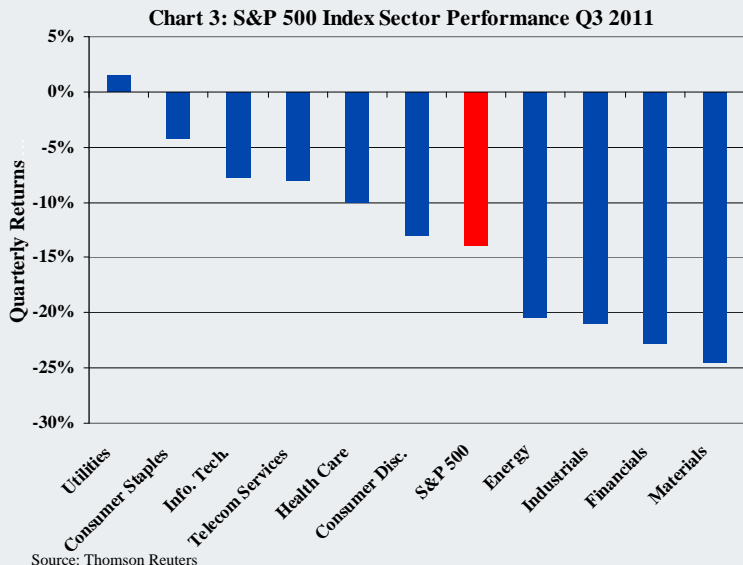
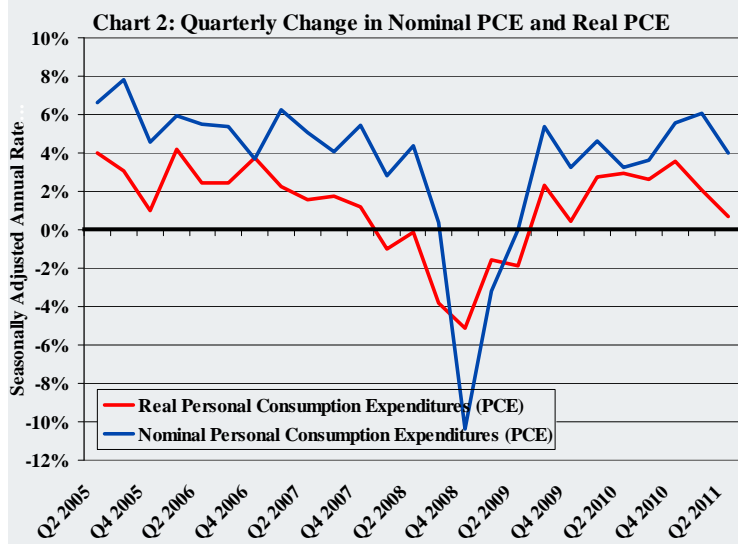
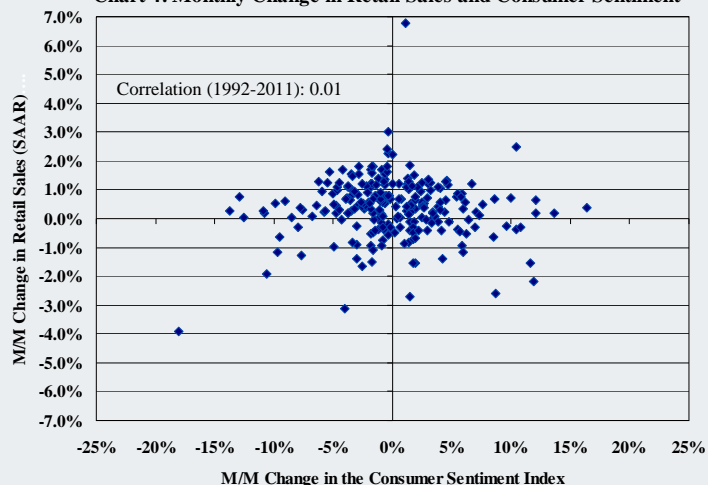
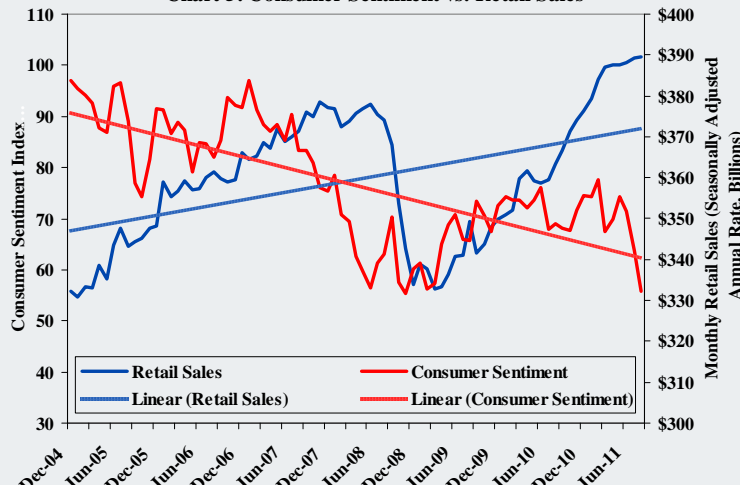


Chart 4: Monthly Change in Retail Sales and Consumer Sentiment



Source: Commerce Department, Reuters/University of Michigan

Chart 5: Consumer Sentiment vs. Retail Sales



Source: Commerce Department, Reuters/University of Michigan

Muted Economic Growth Ahead, But Continued Differentiated Sector Performance

We see a low likelihood of strong, above-trend U.S. economic growth in the near and medium-term, as we discussed at the beginning of 2011. Factors like reduced government spending, less credit available to marginal borrowers, less leverage on both corporate and personal balance sheets and slower emerging market growth will constrain growth to a moderate pace, but these and other factors are unlikely to produce a recession. At the same time, we think that it is unlikely European leaders will allow the damage from the sovereign debt difficulties to systematically undermine European banks and set off a global financial crisis. The economic evidence continues to point to moderate economic growth in the U.S., despite concerns that financial market weakness will hurt economic activity and corporate earnings.

We have seen continued strength in the hard economic data recently, even as many sentiment readings slumped last quarter. This hard economic data is not released as quickly as the softer sentiment surveys, but we put more weight on the hard data in our analysis as sentiment readings are not predictive of individuals' or companies' actions. Chart 4, for example, shows that there is essentially no correlation between monthly changes in consumer sentiment and retail spending. Chart 5 examines these two indicators on a longer-term basis and demonstrates that consumer sentiment has trended lower over the last six years, while retail spending has increased to new all-time highs over the same period.

Just as there has been a divergence between sentiment readings and other economic data, there has also been a divergence between companies' and traders' assessments of the economic environment. Many executives have said that business remains strong, particularly for companies in consumer and technology oriented businesses. Bed Bath and Beyond, Inc. last month reported strong quarterly sales and earnings growth in its U.S. focused business, while Oracle, Inc and Nike, Inc. delivered strong growth in the U.S. and abroad. Managements from each of these Large-Cap Core Equity portfolio companies ex-

pressed a positive view of conditions in their markets, and Oracle even emphasized that they continue to hire in Europe and around the world. But we also follow comments from other market-leading companies, like Marriot International, Inc., which has a valuable global perspective on consumer and business spending. Marriott's President and COO, Arne Sorenson, said "We are seeing no signs of weakness in our business today... Business people are still holding meetings and still traveling, and our leisure business is quite good."

We remain confident in our outlook, but acknowledge that there are still risks to our view. Severe and sustained losses in traditional investments like stocks and bonds could undermine consumer spending, particularly from high-end consumers that drive overall spending. In addition, another round of quantitative easing could again drive up commodity prices, and foster inflation fears.

The foundation for moderate economic growth in the U.S. looks solid despite these risks. Healthy personal income growth and limited layoffs should support consumer spending. The fundamentals for high-end consumers look even better as the unemployment rate for workers with a college degree has fallen to 4.2%. Business spending should also remain strong in the environment ahead. High corporate profits and record levels of cash on corporate balance sheets in an uncertain economic environment give us confidence that businesses are likely to emphasize investment in technology to enhance productivity, and in turn, boost profit growth. We should continue to see differentiated Sector performance, and we believe the Large-Cap Core Equity portfolio with significant allocations to the Consumer Discretionary Sector and the Information Technology Sector is well positioned for the period ahead.

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