Pzena Investment Management
Second Quarter 2009 Commentary

Despite the recent run-up in valuations, we believe there is a significant amount of upside left, both for the market and particularly for our portfolios. A deep value strategy has generated over 400 basis points per annum of excess return in prior cycles, even after excluding the "best" value environments.

Is it Over?

A mere four months ago the investment community was mired in a environment that was becoming more desperate by the day, characterized by continued economic deterioration, frozen credit markets, and equity markets that had declined by over 50% from their peak in October 2007. The question on investor's minds was whether this was the precursor to the next Great Depression. But what a difference those four months have made. Stimulated by massive government intervention globally, equity markets have staged an impressive rebound as can be seen in the following table:

Strong Value Returns from March 10, 2009 - June 30, 2009

Pzena Global Value*	63.7%
Pzena Large Cap Value*	62.7%
MSCI World,SM net	41.5%
S&P 500®	37.0%
Russell 3000® Value	41.0%
Russell 3000®Growth	36.3%

*All gross returns through 6/30/09; Full historic performance records available on each product page

Source: Russell, MSCI, S&P, Pzena

Only time will tell if this rally is the real turning point, but it does illustrate the historical experience of quick, sharp moves off market bottoms and the power of a valuation based investment strategy during the early stages of recovery.

But now that we have experienced a strong rebound in performance, the question is: "Is it over?" "Did we miss the big re-valuation opportunity?" Our analysis of current valuations and examination of past market cycles leads us to believe that it is not over, and that the evidence provides us reason to believe there is still a considerable amount of upside left to go. We premise this observation on the following:

- Valuations are now only at recessionary levels,
- Earnings normalization has yet to occur, and
- Value strategies have fared well during an economic recovery, even in a low growth / high inflation environment.

Valuations Back To Recession Levels

We might describe the recent market upturn as the pullback from the depression scenario. As can be seen in Figure 1, broad market valuations have rebounded to levels more normally seen in recessions, with our model showing the S&P 500 at a 36% discount to fair value. Our portfolios are no different; although off a historical low, our longest running portfolio, Pzena Value, has a price-to-normal earnings ratio among the lowest it has been in our 13 ½ year history (Figure 2).

But the question remains, are all of the excess returns for value earned during the sharp initial run in the cycle? We know that over the long term, a deep value portfolio outperforms the S&P 500 by more than 500 basis points per year. But how would the investor who has missed all of the "best" value opportunities have fared over that 40+ year span? Then answer is telling – even when missing the "easy money" periods, a value strategy outperformed the S&P 500 by more than 400 basis points per year:

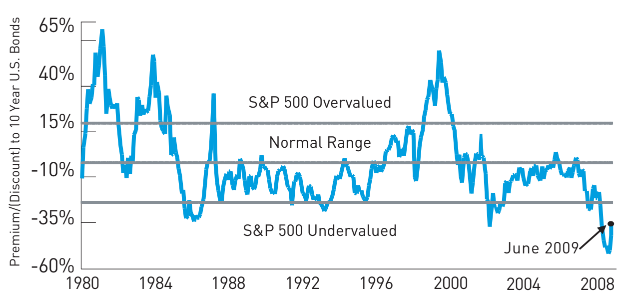
Performance of Value Strategies 1965 - 2009

	S&P 500	Largest 1000 Value*	Difference
Total Period	8.8%	14.0%	5.2%
Excluding "Best" Value Environments	9.3%	13.7%	4.4%

"Best" Value environments defined as periods when valuation spreads wider than one standard deviation from the mean
*Cheapest quintile of largest 1000 U.S. listed companies

Source: Sanford C. Bernstein, Pzena Analysis

Figure 1: S&P 500® Valuation Relative to Bond Market



Source: Sanford C. Bernstein & Co., Pzena Analysis

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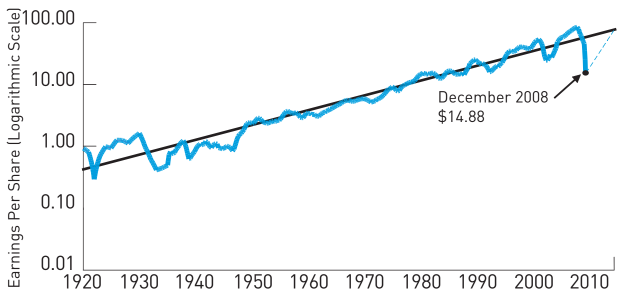
We expect this time will be no different. In fact, the overall low valuations in our portfolios cause us to believe that the returns going forward "should" outperform the historical average.

Earnings Normalization Yet to Occur

As can be seen in Figure 3, S&P 500 earnings are at a cyclical trough, with the magnitude of this cycle's earnings decline unmatched since the 1930's. Now that an improvement in investor sentiment has helped valuations recover from depression-case levels, earnings normalization will likely be an important factor in future returns. As can be seen in Figure 4, the S&P 500's return on equity (ROE) was at a nadir in 2008: 2.8% versus an average of 14.1% for the 38 year period since 1970. A return to only average ROE's would result in S&P 500 earnings of approximately $88 five years from now, versus a 2008 trough of $14.88 and 2009 estimates of $28. One does not need to make heroic assumptions either about achieving new peaks in economic activity to reach this new "normal"; S&P 500 earnings reached almost $85 in 2006. In fact, many of our portfolio companies' financial models only call for recovery to 2006/07 levels. Based on the current level of the S&P 500, valuation of our portfolio (Figure 2), and the effect of ROE normalization, expected annual returns over the next five years are 12.4% for the market, and 18.9% for our portfolio. This gives us reason to believe that earnings normalization can be a powerful value creator for a number of years.

We are, however, in unchartered territory – both banks and consumers are in the process of de-leveraging; history tells us that recoveries following financial crises tend to be muted, more "L" shaped than "V" shaped; and the specter of inflation looms in the wake of massive government stimulus. In essence... is there a new "normal"? We will examine the most recent historical period characterized by low growth and high inflation – the 1970's – and observe how value investing performed during that period.

Figure 3: Earnings Recovery Provides Significant Upside for Stocks
S&P 500 Earnings Per Share



Source: Robert Shiller, Pzena Analysis

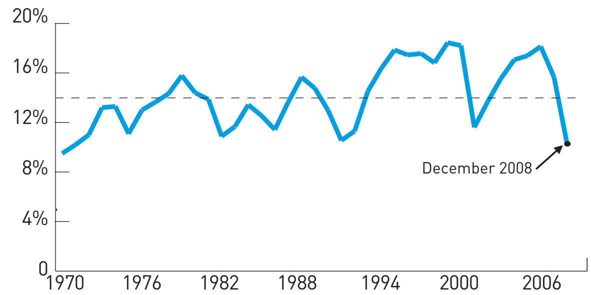
Value Thrived During the 1970's

The economic environment during the 1970's cycle, measured from the September 1974 trough through the June 1982 trough, was characterized by low growth and high inflation. Annual GDP growth averaged 2.5 % versus the 3.2% long term average, and the annual increase in CPI was 8.8%. Despite challenging conditions and inevitable cyclicality, corporate managements were able to adapt to the new conditions and restored ROE's virtually to historical levels (13.4% versus the long term average of 14.1% - see Figure 4). Value strategies performed well in this cycle.

Figure 2: Pzena Value Price-to-Normal Earnings

Source: Pzena Analysis

Figure 4: S&P 500 ROE at Cyclical Trough[1]
1970 Through 2008



[1] S&P 500 beginning in 1960. Adjusted for nonrecurring and extraordinary items
Source: Standard & Poor's; Empirical Research Partners Analysis

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The cheapest (based on price-to-book ratio) quintile of the largest 1000 U.S. listed companies returned 22.4% per annum over the almost 8 year period, versus 10.8% per annum for the S&P 500. Cumulatively this translates into a 386% cumulative return for the cheapest quintile versus 123% for the S&P 500. When measured against the 8.8% inflation rate, real returns were quite healthy for the low price-to-book strategy.

An interesting sidelight to the discussion involves the generally accepted thought that energy and commodities are good places to be during inflationary periods. While the logic behind the thinking is quite spurious and has been debunked in academic papers, we thought we would see how commodity stocks performed during the inflationary period of the '70s. What we found was that while commodity stocks outperformed the market, they failed to produce returns that were better than a broad deep value portfolio despite massive "real" price increases, particularly in oil. The energy and materials sectors returned 21.3% and 16.3% per annum, respectively, versus 22.4% for low price-to-book stocks during the 1974 – 1982 cycle.

Conclusion

Despite the recent run-up in valuations, we believe that there is a significant amount of upside left, both for the market and particularly for our portfolios. Attractive portfolio valuations coupled with the power of earnings recovery and the historical evidence of companies' ability to generate normalized returns even in a low growth economy give us tangible evidence to believe that the environment for value outperformance is still quite good.■

DISCLOSURES

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.