

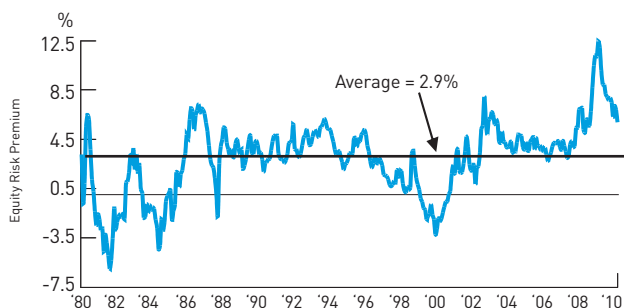
Investment committees are considering whether to re-risk, de-risk, or hold steady. With the expected return on equities at attractive levels, we believe it is a good time for equity exposure.

The Way Forward

As equity markets fell in 2008 and early 2009, investors ran for cover, moving an unprecedented amount of capital to the sidelines in the form of cash and fixed income securities. But now that equity valuations have recovered and the economic outlook is showing signs of stabilizing, investment committees are considering whether this is the time to re-risk, de-risk, or hold steady with existing investment policies. Despite the promise of lower volatility and a “smoother ride” from higher allocations to fixed income investments and alternatives, our analysis suggests that this is an opportune moment to be an equity investor, and particularly a value investor. We offer the following observations:

- Equities in general are attractively valued, and the equity risk premium is wider than normal;
- Companies are well positioned to expand margins and substantially increase profitability, having slashed operating costs and strengthened their balance sheets during the downturn; and
- Leading companies have positioned themselves to weather a wide range of economic scenarios, and require only modest top-line growth to generate meaningful profit improvement.

Figure 1: Equity Risk Premium at Attractive Levels



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

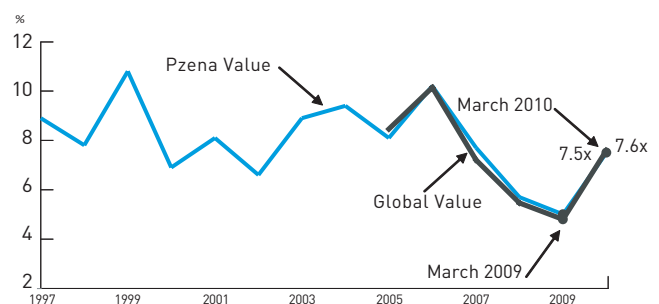
Why Equities – Why Now

First we examine the relative attractiveness of equity investments versus fixed income alternatives from a high-level perspective. Figure 1 presents the risk premium investors have assigned to equities in the US market over the last 30 years. The current risk premium, defined as the expected return on equities less the risk free rate, is at a very attractive level: 5.9%, versus an average of 2.9% over the last 30 years. Other than the once-in-a-generation peak reached during the recent financial crisis, we have only seen this wide a premium four times in the last 30 years. Today, based on our dividend discount model, the expected return on equities is 9.7%, a substantial premium to 10-year treasury yields of 3.8% and yields on corporate debt of 4.6%.

As we drill down to a portfolio-level perspective, we have a similar observation. For both our US Value and Global Value portfolios (Figure 2), we find valuation levels to be very attractive using our internal price-to-normal earnings valuations, surpassed only by the extremes reached during the market meltdown of 2008.

Despite these positive indicators for equities, the refrain from investors is that there’s a “new normal;” that de-leveraging and a weakened consumer will result in, at best, tepid GDP growth and modest top-line gains, stunting the opportunity for equities. History suggests that economic recoveries following financial crises are more muted than traditional upturns coming out of recession. We do not dispute the likelihood of a modest recovery – in fact, this scenario underlies our bottom-up company analyses. Despite this cautious view, we find that a slow-growth economy and robust equity returns are not mutually exclusive, but rather the opposite is true – because of management’s aggressive cost-cutting and adaptation to the

Figure 2: Portfolio Absolute Valuation Levels are Attractive
Pzena Value and Global Value Price-to-Normal Earnings



Source: Pzena Analysis

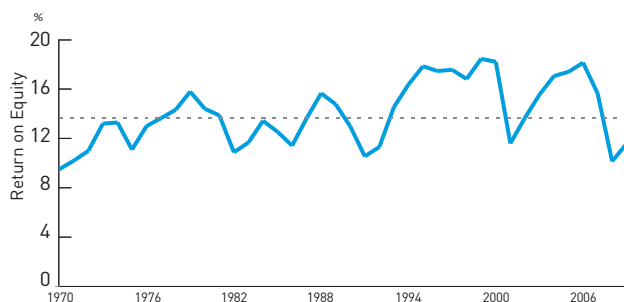
“new normal,” profitability is already being restored, cash flow is robust, and modest incremental revenue gains can result in continued margin expansion and increased profitability. We believe this is the fundamental support for attractive equity returns going forward.

Companies Adapt to the “New Normal”

Managements around the world almost in unison reacted to this recession as a permanent reset of the global economy to a lower level, as opposed to other downturns that were viewed as temporary setbacks to be followed by even stronger recoveries. The result was a swift adjustment of operating costs, inventory levels, and capital expenditures, which arrested the decline in profitability and left corporate balance sheets with low leverage and substantial cash hoards (recent reports indicate over \$800 billion of cash on US corporate balance sheets alone). Figure 3 illustrates the effect of these actions; corporate returns troughed during mid-2009, and steadily improved through the second half of 2009, well on their way to reaching their long term average 13.5% return on equity. Companies are investing only where returns are good, not on the hopes of a robust recovery. This pattern is not unlike other downturns, where managements take action to adapt to the new environment and restore returns to their long term history.

But do we need to get back to prior peaks to enjoy the return potential discussed above? Our analyses indicate the answer is no. Our underlying revenue growth assumption used in developing the five-year-out normal earnings estimates for our Pzena Global Value portfolio is on average 4.9%, which is only about half the 9.6% revenue growth rate experienced during the last economic cycle. We are encouraged further by the balance sheet strength of our holdings (Figure 4) and the quality of the

Figure 3: S&P 500 Return on Equity at Cyclical Trough
S&P 500 Return on Equity* 1970 - 2009



Source: Standard & Poor's, Empirical Research Partners Analysis
*Adjusted for nonrecurring and extraordinary items

business franchises in the portfolio, giving them the flexibility to weather a wide range of macroeconomic environments on their way to recovery. Not every company, however, is in this position. This is an environment where companies differentiate themselves based on their ability to adapt to the new realities, favoring companies with flexible cost structures and management nimbleness. Stock selection is critical in this part of the cycle.

Equities Offer Superior Return

With valuations attractive, expected returns above normal, and companies well positioned to increase profitability, what is the potential tradeoff between exposure to equities, hedge funds, and bonds? Let's look at the comparative return of a deep value versus a “low risk / low volatility” hedge fund alternative as well as corporate bonds. In Figure 5 on page 16, we calculate the expected future return for each investment alternative based on its historical long term excess return (alpha) and return generated from market exposure, on a net-of-fee basis. Our observation is that the expected return of a deep value portfolio is significantly greater than those hedge fund and fixed income alternatives illustrated.

Summary

A forward-looking view and even-minded analysis of investment alternatives suggests that the equity opportunity today is significant. With the expected return on equities at attractive levels, we believe it is a good time for equity exposure. ■

Figure 4: Portfolio Fundamentally Well Positioned
Conservative Balance Sheets

	Net Debt to EBIT**	Net Debt to EBITDA***
Global Value Universe*	2.53x	1.02x
Pzena Global Value Portfolio	1.82x	0.92x

*500 Largest U.S. companies and 1,500 Largest non-U.S. companies
Note: Universe and portfolio are both ex-financials and utilities (as of 3/31/10)
**EBIT - Earnings before interest and taxes
***EBITDA - Earnings before interest, taxes, depreciation, and amortization

Source: Capital IQ, Pzena Analysis

Figure 5: Deep Value Offers Superior Returns

	<u>Equity Long/Short*</u>	<u>Deep Value Portfolio</u>
Expected Gross Alpha per Annum	6.0%	3.0%
Plus: Return from Net Market Exposure		
Expected Return of S&P 500	9.7%	9.7%
x Market Exposure	<u>0.436</u>	<u>1.00</u>
Market Return	<u>4.2%</u>	<u>9.7%</u>
Expected Gross Return per Annum	10.3%	12.7%
Less: Fees		
Management Fee	1.0	0.7
Performance Fee (20% for long/short strategy)	1.9	----
Net Expected Return per Annum	<u>7.4%</u>	<u>12.0%</u>
Historic Volatility**	<u>8.7%</u>	<u>18.0%</u>
Comparable Bond Return:		
Barclay's Aggregate U.S. Corporate Bond Yield	<u>4.6%</u>	

* Equity Long/Short alpha and market exposure derived from a regression of 10 year index returns

** Based on trailing 10 year history

Source: Hedge Fund Research, Inc., (c) 2010, www.hedgefundresearch.com, Bloomberg, Pzena Analysis

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.