

August 21, 2009

The year 2009 has been a challenging year for investment managers who focus on high quality companies that are distinguished by sound financial health, stronger profitability and effective management that have demonstrated the ability to deliver above-average earnings growth. The first two months of the year were marked by fears of a very deep recession and extreme levels of risk aversion. High quality, fundamentally sound companies with good earnings growth potential performed best in this environment. In March, though, the tide turned and risk came back into vogue. During the 2nd quarter, the best performing stocks were lower quality, risky, high beta stocks with questionable earnings growth potential. As fears of an economic depression subsided and investor confidence improved, the prevailing strategy was to reach for stocks with the greatest opportunity for stock price reversion with little regard for risk to company fundamentals.

As stocks continued to move higher through July, we have seen a continuation of many of these same high risk themes driving the market. The leaders have included stocks with higher volatility and leverage characteristics, as well as “deep value” companies with low Price/Book valuations, particularly those found in the Financial Services and Consumer Discretionary sectors. Continued declines in credit spreads have also contributed to the favorable sentiment for higher beta securities. Improving economic data, the successful completion of the government’s bank stress tests and better than expected 2nd quarter earnings results led many investors to believe that companies with weaker financials and fundamentals can survive. Such companies, due to their low valuations, have offered an opportunity for aggressive investors to reap large profits quickly. As such, investment strategies that are underweight these types of companies, including Westwood portfolios, have underperformed their benchmarks.

An example of this lower quality theme has been the homebuilding industry. Homebuilders, in general, have performed well in this rally, and the best performing homebuilding stocks have been those with the most leveraged balance sheets. While there have been some encouraging data points recently, industry fundamentals remain considerably weak, new home financing is still challenging, and the balance sheets and free cash flow generation of many builders remain under pressure. We have avoided this sector as we are also concerned that coming waves of bank owned inventory hitting the market, somewhat deferred by foreclosure moratoria, will compete with new construction. It is difficult for us to justify these moves in the stock prices and valuations given the significant challenges these companies face.

Also in the month of July, the lower quality companies whose fortunes are tied to the consumer, (such as autos, consumer durables, and retailers) all significantly outperformed their financially stronger industry peers. The common denominators between these companies were weak balance sheets and suspect earnings growth potential coupled with low price to book values. We believe the short term effect of stimulus on demand and inventories has created a level of euphoria relative to the inherent value of their future earnings power. Two of the factors that will need to be seen for significant improvement for consumer-related industries to produce meaningful earnings growth are consumer spending and employment growth. While there have been small signs of improved consumer spending and jobless claims, the market has rewarded results that are “less worse” or simply a slowing of the pace of decline, rather than growth. Combining these factors with tight credit markets, and continued consumer deleveraging, it is difficult to make an investment case for many of these lesser quality stocks

that have led the rally thus far. Simply said, we do not believe that the fundamentals support the valuations of many of the stocks within these industries.

Large Cap bank names have been a very visible sector in which divergence has been significant. Bank stock that reported *negative* 2Q09 earnings and are expected to produce *negative* earnings through 2010 have increased 37.5% over the last 30 days, while banks that reported *positive* 2Q09 earnings and are expected to generate positive earnings through 2010 increased just 21.7%. Given the still uncertain health of the banking industry, which includes rising credit losses and still very weak loan growth, we feel it's unlikely that the lower quality banks can continue to generate this type of out-performance.

While we recognize that our bias towards quality has been out of favor in the recent rally, we have not deviated from our investment process. Emphasis on our investment process, philosophy, and risk management has been the historical driver of our success. As a result, we continue to focus on companies with attractive fundamentals, including strong free cash flow, low debt, revenue visibility, and exposure to faster growing foreign markets.

We do recognize that turning points in the economy often provide an opportunity to profit from companies that are better positioned to grow earnings over the coming 12 – 24 months. As a result, we have begun to find and add economically sensitive securities to our portfolios that are likely to experience margin expansion and greater earnings growth as the global economy recovers. However, the risky stocks that have led the rally thus far are currently pricing in a rate of future economic growth that is unrealistic given the weak outlook for employment and consumer spending.

Our focus on high quality companies can cause us to lag the benchmark around market inflection points, especially when they are of such character as the current rally. However, these periods are usually short in their duration and we have historically outperformed our benchmarks following the initial stages of an economic recovery when liquidity and risk appetites return to more normalized levels. Given the magnitude of this rally, with the market up some 50% from its March low, the likelihood of it persisting in its current form is doubtful. As the rally matures and investors begin to price in a more realistic level of future economic growth, we are confident that market leadership will revert back to the types of companies we favor.

Thank you for your continued support of Westwood. Please call us if you have any questions.

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