

Producing Risk-Adjusted Returns Through Equity and Fixed Income Styles Built Upon a Common Philosophy

Because our equity and fixed income styles are built upon a common philosophy and a firm-wide thought process, they provide the solid basis for an effective, consistent balanced investment strategy. Both strategies emphasize long-term risk-adjusted returns with a well-defined, proven selection methodology.

Asset Allocation Approach

Our balanced investment style centers on the proven benefits of asset allocation. We can manage to any existing allocation policy, or help clients develop the policy that best meets their needs. The mix of securities selected is adjusted proportionately to the client's specific range.

When developing allocations, we use a structured methodology incorporating three inputs to help us develop an accurate appraisal of the market's risk/return potential:

- 1.** A *relative value model* (stocks v. bonds) allows us to determine an expected equity return premium, which we can then compare to long-term averages.
- 2.** *Valuation* (relative to history) helps us determine whether asset classes are over or undervalued.
- 3.** We assess *liquidity* by examining monetary trends, as well as the level and direction of short-term interest rates, to determine the economy's effect on financial markets.

Judgment on the weight of the evidence from these methodologies translates to an allocation of stocks and bonds.

Value Equity Investment Component

Believing that sound strategies, executed consistently, are the key to long-term investment success, Great Lakes Advisors builds value equity portfolios through a distinctive investment philosophy and process. This approach, which manages risk as a key component, has performed well through a wide variety of market climates. What's more, it can be customized to the needs and preferences of clients who desire socially responsible investing.

Since 1985, the heart of our equity investment approach has centered around a firm's potential to improve its value, or earning power. We define earning power as a company's ability to generate profit to reinvest into the firm or distribute to shareholders, and consider such measures as return on capital/equity as indicators of company strength.

Selecting from a universe of companies with large–medium capitalizations, we seek to invest in established firms and industries, which we believe will increase their earning power, and whose current valuations suggest that they are underpriced because of low market expectations.

Central to our philosophy and process is a unique way of diversifying the portfolio across industries to manage risk. The result has been a portfolio that has demonstrated competitive returns, low volatility compared to the market and other managers as a whole, and low turnover.

Our Value Equity Investment Process

We identify appropriate stocks and build portfolios through a rigorous process:

1 *Generate investment ideas* from carefully chosen research sources. We use data from price and profitability screens, corporate financials, and information from company and industry meetings and presentations. Companies exhibiting potential to improve returns on capital/equity particularly attract our attention.

2 *Build a case for a particular holding* by identifying reasons the company may achieve or sustain above-average return on capital and/or equity. We focus on changes that are likely to have a positive long-term effect on return on capital, such as:

- Improved margins and/or balance sheet,
- Better utilization of assets and cash flow,
- Changes in the management team and/or industry structure.

3 *Assess the attractiveness of current valuation* of earning power, including price/earnings ratios and dividend yields—measures that have been proven for decades to produce investment success.

4 *Determine the enhancement to the portfolio.* The selection should have a positive impact on the overall portfolio direction and diversification. We add stocks to the portfolio to:

- Increase portfolio average earning power,
- Improve average valuation measures,
- Enhance overall diversification.

A Well-Defined Sell Discipline

When we purchase a stock, we establish a total return target for the holding period. We anticipate that the total expected return should clearly exceed the long-term return of the overall market.

We monitor company progress after purchase and usually sell after achieving the desired return. However, other factors may prompt a reexamination of our strategy and an earlier or later sale based on a different total return target.

Some reasons include:

- Improvement or deterioration of the *investment case*,
- Major changes to the *business structure* or *earning power*,
- *Another stock* offers better diversification.

Fixed Income Investment Component

Our active approach to fixed income management is built upon relative value investing, with the goal of producing a better return over the long term while minimizing volatility. This approach follows our belief that income is a significant and predictable component of total return over time, where price fluctuations can be volatile. We build the fixed income portion of our balanced portfolios through a bottom-up approach that also:

- *Actively manages* issues, sector, quality and yield curve positions,
- *Focuses on* maximizing the overall portfolio *income* level,
- *Seeks quality* by using only investment-grade issues (BBB and above),
- *Manages interest rate risk* by constraining duration around a target benchmark (we can manage portfolios around a wide variety of benchmarks).

Both our selection process and risk controls combine sophisticated portfolio analysis and security valuation models with professional judgment designed to add value through:

- *Maximizing portfolio income* and its reinvestment,
- *Superior* structure and credit *analysis*,
- Adept and opportunistic *trading*.

Just as important, our fixed income portfolios de-emphasize potential risk by:

- *Avoiding* market timing,
- *Maintaining* a high-quality average credit rating,
- *Selecting* liquid issues.

Our Fixed Income Investment Process

Our process for managing fixed income investments begins with an assessment of the trends exhibited by each sector. Our focus primarily is on capturing the beneficial effects of long-term trends, rather than making short-term tactical realignments. The factors we assess include:

- Structural *risk/return* trade-offs,
- *Credit* trends,
- Historical *yield spreads*,
- Shape of *yield curve*,
- *Supply/demand*.

Once we have identified sectors offering the best long-term value, we focus on selecting individual issues that offer sufficient liquidity, a meaningful return/risk trade-off, and the likelihood of increasing portfolio income.

Risk Management Through Diversification

We believe that a superior risk management strategy for both equity and fixed income investments is diversification across industries/sectors, rather than market timing. Through this strategy, we are able to increase the likelihood of superior returns in most market climates. Our objective is to ensure that portfolios are neither concentrated nor index-like, but always well-diversified.

For equities, by taking a position in a company, we attempt to gain the benefits of positive changes within its industry as a whole, as well as developments specific to that firm. We endeavor to invest in industries that together represent half of the S&P 500's market value.

For fixed income, we overweight the sectors offering the best long-term value opportunities. In addition, we limit corporate bond positions to 5 percent in one specific issuer. To manage interest rate risk, we keep our portfolios' duration within ten percent of the market benchmarks.

We approach portfolios as investors, not traders, making equity purchases with the intent of holding the securities for at least three years. We typically hold 35 to 50 stocks in the equity portions of our balanced portfolios and about 40 issues in the fixed-income portion.

In Summary...

Great Lakes Advisors provides our clients with:

- A proven approach to balanced investing implemented consistently.
- A value equity component based upon established companies building earning power and priced attractively.
- A fixed income component built upon long-term relative value and income streams.
- Competitive returns with lower volatility than the market and other managers as a whole.
- Skilled, experienced investors, and proactive service that keeps clients informed and involved.



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