



# Second Quarter 2003 Market Commentary



From Various Portfolio Managers at  
Citigroup Asset Management



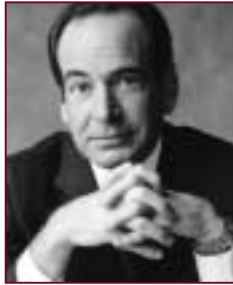
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Alan Blake,  
Portfolio Manager

25 years of investment  
experience

## Investment Discipline: Equity—Large Capitalization Growth

After more than three dismal years, U.S. securities markets in the second quarter of 2003 recorded their strongest performance since the end of 1998. We are encouraged by the rebound in investor confidence following the quick resolution of the war in Iraq, and by positive steps being taken towards political stabilization and peace elsewhere in the Middle East. In addition, we believe the scathing headlines regarding corporate governance are becoming a thing of the past.

The pace of growth the U.S. economy experienced in the second quarter was unremarkable, but it is showing signs of life as productivity and manufacturing continue to improve. The weakness of the U.S. dollar has made U.S. goods and services more competitive abroad, and should provide foreign exchange benefits to the earnings of large-capitalization multi-national companies. We also believe the combined effects of positive monetary and fiscal policies may create sufficient stimulus to reaccelerate growth of the economy. Alternative asset classes, such as cash and fixed income, have become noncompetitive for many investors in this low interest rate environment.

We feel that we are in a 'winner take all' environment, where the companies that possess end-to-end solutions, superior products and maintain pricing flexibility will gain disproportionate market share. Most of the large-capitalization companies we own not only weathered the economic (and market) decline, but actually increased the quality of their balance sheets by increasing cash, and by refinancing expensive debt. With long-term interest rates at a 45-year low, and an insatiable appetite for debt instruments, many of our companies have tapped the corporate bond market and commercial paper market, not because they have to, but because it makes financial sense—it is very cheap financing.

Many of the companies that we invest in have also rethought their strategies on increasing value to shareholders. Companies that had significant share buybacks in place have either decided, or are in the process of deciding, to pay, or increase their current dividend in light of favorable tax treatment for dividends.

Our major concentrations continue to be in the areas of Consumer and Media, Technology, Financial Services and Healthcare.

The global media franchises are now seeing a better advertising environment, improving traffic at theme parks, lower production and studio costs, and excellent box office and DVD sales.

The much-maligned technology sector is in the midst of an upgrade cycle. We feel that the drive to wireless LAN, and Wi-Fi applications are gaining traction and are setting the stage for the next cycle.

In terms of Healthcare, our feeling is the environment is as good as it has been in many years. An industry-friendly FDA has approved products and therapies at an unprecedented pace. Also, a bi-partisan Medicare drug benefit bill is likely to pass later this year, doing away with an uncertainty in the industry as well as muting the ability to use this industry as a 'whipping post' for political agendas leading into an election year.

We believe our portfolio is well positioned to benefit from the improving trends cited above. Thank you for your continued support as we emerge from this difficult period of time.

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Hersh Cohen,  
Portfolio Manager

34 years of investment  
experience



Scott Glasser,  
Portfolio Manager

10 years of investment  
experience

## Investment Discipline: Equity—Large Capitalization

In our March quarterly letter, we offered several arguments why the three-year bear market was over, and why a durable bottom for the stock market had been put in place. In our year-end letter, and again in March, we discussed how so much negative news was already “baked into” stock prices. It was our belief that developments were much more likely to contain upside surprises than any new factors that could shake the markets. The powerful rally in the most recent quarter certainly indicates that the heavy selling pressures that dominated 2002 had dissipated. Stocks had a broad-based advance, despite a lack of any particular positive economic statistics. Business continued to be frustratingly soft and few companies reported any signs of improvement. By continuing to lower interest rates, the Federal Reserve (“Fed”) amply demonstrated its concern with the refusal of the economy to grow materially in the aftermath of the party of the late 1990’s. But stocks had been so thoroughly washed out, and competition from interest-bearing securities, including money funds, so low, that a strong rally took many by surprise.

So the stock market has moved well into positive territory, and signs of animal spirits have returned. In contrast to our very bullish stance of the first quarter, we now have a more muted view of the period immediately ahead. It is not a view that the market must decline, but rather the belief that to fuel further material gains, the economy must begin to show substantial improvement. The stock market’s huge rally, with negligible improvement in the economy, was justified by the enormous rate drop and the accompanying bulge in liquidity, combined with the reversal of overwhelmingly negative sentiment. It almost seemed to us that the Fed was trying to drive the flow of money out of the mountain of money funds and into stocks in order to reverse the negative wealth effect of the brutal bear market. And while we spoke of the potential upside surprises this year, we are most in awe of the Fed’s ability to have generated yet another round of mortgage refinancings. It is that latest surge in refinancings that has kept the consumer afloat. But it seems to us that while the Fed has succeeded in keeping the economy from getting materially worse, it has just about run out of monetary options to give it a kick start to the upside. Now we need to see the economy get going, which would lead to higher corporate earnings, and ultimately more capital spending and employment increases.

The lingering economic malaise, despite the very low interest rates, is what led us to begin last September to advocate massive fiscal stimulus in the form of tax cuts. Simply put, the economy needs more than low rates, and tax cuts seem the best option. Whether one is Democrat or Republican, or whether one agrees or disagrees with the distribution or fairness of the cuts (and we have our own issues), it is hard to deny that they are highly stimulative. Everyone will receive more money in his or her paychecks beginning in July. We seem to have learned lessons from the Great Depression in the 1930’s, and from Japan in the 1990’s, when taxes were raised and economies swooned.

In a sense, these tax cuts represent a very sharp arrow drawn from the quiver of potential stimulative actions. They should have an impact on the economy and it should start to be felt by the third quarter of the year. There are not many good arrows left, thus it is important that we see results.

Our more muted market view for the summer is based on the idea that stocks have gone pretty far on interest rates alone. Now we need to see if the tax cuts have their intended effect. If the evidence begins to support that, as we believe it will, the stock market can resume its uptrend. But if little or no improvement becomes visible, we would have to become more defensive. Thus, we think a protracted sideways-type move is likely for the near future.

It is interesting to note that the rally has been most kind to the most speculative sectors of the markets, while conservative, dividend-paying securities have not been as strong. In our opinion, the new reduction in taxation of dividends has not yet been adequately reflected in prices. Therefore, we are still finding lots of blue-chip companies whose dividend yields are two, three and four times those of money funds. There is a watershed change for individuals in the treatment of income from investing, and we believe it has a long way to play out. Historically, interest on borrowings was tax-deductible, while dividends from stocks were taxed at an individual's highest marginal tax rate. Based on the new dividend tax reduction, it now makes more sense for individuals to own stocks with current yield and a history of dividend increases.

Thus, because the market has done a great job of eliminating its pessimism and under-valuations, we cannot have the same level of enthusiasm until signs appear that corporate earnings will ratchet up. While we think that is a likely outcome, market participants might become hesitant to add holdings at current levels before seeing a bit of evidence. We will continue to focus, as we always have, on the higher quality stocks. That, in our opinion, is where the best values are, especially in light of the new tax laws.

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Jack Cunningham,  
Portfolio Manager

14 years of investment  
experience

## Investment Discipline: Equity—Large Capitalization Value

The U.S. equity markets rebounded strongly during the second quarter, with all the major domestic stock market indices posting double-digit returns. The S&P 500 Index,<sup>9</sup> for example, had its best quarter since 1998, gaining 15.4% for the period. The Nasdaq Composite Index<sup>10</sup> increased 21.1%. Value outperformed growth during the period as measured by the S&P 500 Barra Value index,<sup>11</sup> which gained 18.8% versus a 12.2% return for its growth counterpart, the S&P 500 Barra Growth index,<sup>12</sup> respectively.

During the second quarter, investors in U.S. equities responded to a number of positive developments. They included the end of the war in Iraq, a rebound in consumer confidence and improved corporate profits, which all helped buoy stocks. Accommodative monetary and fiscal policy also contributed to the market's advance. On the monetary front, the Fed<sup>13</sup> lowered its target for the fed funds rate<sup>14</sup> another 25 basis points (*i.e.*, 0.25%)<sup>15</sup> to 1.0%, a 45-year low. Furthermore, the ten-year U.S. Treasury yield also fell to a 45-year low during the quarter. On the fiscal front, Congress passed a \$350 billion tax-reduction package that included rate reductions on capital gains and dividends.

We remain constructive on the U.S. equity market, but we have been reducing selected positions as a result of increased valuations. We are still comfortable with our barbell approach to managing the portfolios. On the one hand, we are overweight defensive stocks versus the portfolio's benchmark, such as the consumer staples sector, which we feel should help cushion performance if the market pulls back. On the other hand, we have been overweight the benchmark index in some higher-beta sectors, like technology and healthcare. Technology, in particular, has performed quite well, and we have been reducing our overweight position and redeploying some of the proceeds back into consumer staples, which have lagged many other industries during this rebound and, in our opinion, still offer favorable long-term valuations. With respect to the economy, we expect moderate eco-

<sup>9</sup>The S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Please note that an investor cannot invest directly in an index.

<sup>10</sup>The Nasdaq Composite Index is a market-value weighted index, which measures all securities listed on the Nasdaq stock market. Please note that an investor cannot invest directly in an index.

<sup>11</sup>The S&P 500 Barra Value is a market-capitalization weighted index of stocks in the S&P 500 having lower price-to-book ratios relative to the S&P 500 as a whole. (A price-to-book ratio is the price of a stock compared to the difference between a company's assets and liabilities.) An investor cannot invest directly in an index.

<sup>12</sup>The S&P 500 Barra Growth is a market-capitalization weighted index of stocks in the S&P 500 having higher price-to-book ratios relative to the S&P 500 as a whole. (A price-to-book ratio is the price of a stock compared to the difference between a company's assets and liabilities.) An investor cannot invest directly in an index.

<sup>13</sup>The Fed is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

<sup>14</sup>The fed funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans. The fed funds rate often points to the direction of U.S. interest rates.

<sup>15</sup>A basis point is one one-hundredth (1/100 or 0.01) of one percent.

conomic growth in the second half of this year, driven by continued growth in consumer spending and an increase in business spending. We believe the major U.S. equity indices can potentially sustain further gains from here, but in order to advance meaningfully, we think the market needs to see further signs of economic and corporate-profit growth.

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Richie Freeman,  
Portfolio Manager

27 years of investment  
experience

## Investment Discipline: Equity—Multi-Capitalization Growth

The second quarter of 2003 witnessed a continuation of a number of positive trends exhibited by the Multi Cap Growth portfolios in the first three months of the year. The result was solid absolute and relative performance in the portfolio. The upside was not related to, or limited to, the performance of a single stock or industry group, but rather due to broad-based strength across a number of sectors and across a variety of our holdings. The areas that generated solid returns included healthcare, technology, financial services and select cable/media holdings. We are pleased to report that in spite of the three-year bear market in U.S. equities, during the past quarter a number of our stocks recorded all-time highs. We believe it is a reflection of the positive business trends that the companies are experiencing in their respective industries.

During the second quarter, the Federal Reserve implemented an unprecedented 13th straight cut in short-term interest rates, which left the fed funds rate<sup>7</sup> at multi-generational lows. The quarter also witnessed the passing of a \$350 billion tax cut which should benefit the consumer in the months ahead. In our first-quarter update, we wrote that:

...while the stock market averages have made little forward progress since the July lows, we detect a strengthening in the market's underlying technical condition. Fewer stocks recorded new lows at the October bottom than in July and fewer still on the recent March pullback to the areas of the 2002 lows. As well, while at its low point this year, the market remained slightly above the summer's lows, public sentiment toward equities grew increasingly more pessimistic. From a contrary standpoint, this increase in bearish sentiment is actually quite constructive in that it reflects actions already taken by investors. Money market funds have now swelled to over \$2 trillion, and the value of money market accounts as a percentage of the Wilshire 5000 Total Market Index<sup>8</sup> is now over 25%, a level even higher than back in 1982, the date that many point to as the start of the last great bull market . . .

While the stock market has rallied sharply from the lows made earlier this year, we continue to believe that the record amount of liquidity present, combined with historically low long- and short-term interest rates, makes U.S. equities an attractive asset class. We are also encouraged by the return of merger activity during the most recent quarter, a positive indicator for the stock market. It is our belief that an improving equity market is fundamental to a pickup in consumer confidence and business spending and, in turn, a healthier economy.

<sup>7</sup>The fed funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans. The fed funds rate often points to the direction of U.S. interest rates.

<sup>8</sup>The Wilshire 5000 Total Market Index is the broadest stock market indicator covering the performance of the entire U.S. equity market, which consists of over 7,000 U.S.-headquartered equity securities individually weighted by market capitalization. Please note that an investor cannot invest directly in an index.

We continue to be excited about the business prospects of the companies in the Multi Cap Growth portfolio. We are encouraged by the ability of many of our companies to generate favorable earnings and cash flow growth in an environment that has been dominated by uncertainty. We believe that this is the trademark of a true growth company. As we go forward, our aim is to own those companies whose businesses are not overly reliant on the cyclical effects of the traditional business cycle.

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John G. Goode,  
Portfolio Manager

33 years of investment  
experience



Peter J. Hable,  
Portfolio Manager

19 years of investment  
experience

## Investment Discipline: Equity—Multi-Capitalization Value

It continues to be our belief that the stock market made a double bottom in July and October of 2002 and that the March lows in 2003, which did not violate levels established last year, represented a successful test. We also believe bear markets end with investors throwing in the towel and this is reflected in the continuing high level of money market fund balances.

There have been only three times in the last 20 years where money market fund assets have been 15% or more of the value of the Wilshire 5000 Total Market Index.<sup>16</sup> The first instance was in 1982 (23%) when short-term interest rates were in double digits. The second came after the first Gulf War in 1991 (17%) when short-term interest rates were still in high single digits. The recent reading of 29% came at a time when short-term interest rates were less than 1%. As we have indicated in other commentaries, we think this is the equivalent of 'stuffing the mattress.' When one sees something like this, it is reasonable to conclude that investors are apprehensive and that many negatives probably are factored into stock prices. Even with the recent 20% move in stocks from the March lows, the money market fund percentage has remained in the area of 25%. When the denominator (Wilshire 5000) rises, this has the effect of reducing the percentage. It is clear that investors are retaining unusually large cash balances at this time.

Corporations have reduced their inventory levels to 40-year lows, reflecting a conservative bias by this segment of the economy. Over the last four decades, the inventory-to-sales ratio ("I/S") has fallen as just-in-time inventory programs and computerization have made companies more efficient where inventory levels are concerned. However, current readings are so far below trend-line that any meaningful pick-up in sales likely will cause reordering to occur throughout the economy.

Finally, we need to comment on the historically high monetary and fiscal stimulation now hitting the U.S. economy. The Federal Reserve has reduced interest rates 13 times since 2000 bringing the federal funds rate<sup>17</sup> from 6.5% to just 1%, a figure not seen since the Eisenhower administration. In addition, the 2003 tax cuts have made features of the 2001 tax cut operative for the first time. Many parts of the 2001 tax cut were not scheduled to become effective until 2004 - 2006. With this year's tax cuts, they now are in effect, retroactive to January 2003. We feel this additional fiscal stimulation will have a pronounced effect on the level of economic activity in coming quarters.

<sup>16</sup>The Wilshire 5000 Total Market Index is the broadest stock market indicator covering the performance of the entire U.S. equity market, which consists of over 7,000 U.S. headquartered equity securities individually weighted by market capitalization. Please note that an investor cannot invest directly in an index.

<sup>17</sup>The fed funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans. The fed funds rate often points to the direction of U.S. interest rates.

Our emphasis has been on companies that would benefit from an economic recovery. As such, we have overweight positions in Technology, Consumer Discretionary and the Basic Materials sectors. Historically, these have outperformed the market in the early stages of an advance. Basic Materials, we believe, also will benefit from the fact that 'hard assets' may become a more important sector in a world where currencies are under pressure and deflationary forces are causing many countries to use very stimulative monetary and fiscal policies.

We feel the new leadership in the stock market may be 'attribute' driven. We are questioned often about which sector or industry will constitute the leadership in an improving stock market. The real answer may be that attributes such as a low multiple of free cash flow, PEG ratios (price-to-earnings to growth ratios)<sup>18</sup> of around 1, and higher yielding stocks may attract investment dollars at the margin. Yield was ignored in the late 1990s, but in the current market environment where longer-term equity returns may be single digit in nature, it will probably count for more.

In addition, we feel our all-cap format may also be important in generating positive relative returns. Many larger companies have done well recently but find their valuations (as measured by their P/E ratios) are stretched. Because these are very large corporations, in many cases, it will be more difficult to grow in the future. A number of leading smaller and mid-cap companies may be the source of out-performance in the months and years ahead.

We believe the market may pause during the early summer and consolidate the gains made since March of this year. Recently the ten- and thirty-day advance decline lines for NYSE stocks have become very overbought. However, we believe stocks will work higher by year-end relative to the June highs. We continue to feel that stocks will outperform bonds and real estate in the next five years. This would reverse the relative performance of the last three years when real estate and bonds outperformed in both absolute and relative terms.

<sup>18</sup>The price/earnings growth (PEG) ratio is calculated by dividing the P/E by the projected earnings growth rate. A PEG above one (1) generally means the company is trading at a premium to its growth rate. Investors usually look for a PEG of one (1) or less.

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Jeffrey Russell,  
Portfolio Manager

21 years of investment  
experience

## Investment Discipline: Equity–International Equity

After the poor first quarter of 2003, non-U.S. equity markets rallied sharply as military tensions and political confrontations lessened. The moderation of global tensions (Iraq, North Korea) and narrowing of corporate fixed-income yield spreads<sup>1</sup> over government debt were clear catalysts for expanded investor risk appetite. The short-term containment of the SARS outbreak also proved a catalyst for deeply oversold equities to rally strongly.

Can the equity market rallies continue? As yet there is limited demonstrable evidence of global economic resurgence. Corporate managements remain appropriately cautious and cost conscious in the absence of a demand groundswell. That said, we believe that non-U.S. stocks continue to offer good risk-adjusted potential returns.

Public policy remains forcefully supportive of economic recovery. Short-term interest rates are at half-century lows in many economies and we believe there to be further scope for interest rate reductions in Europe. Public spending is substituting for depressed business capital spending. And energy prices have declined, though not to the level predicted by some commentators prior to the Iraqi war.

In our view, valuation in many industries remains attractive, with dividend yields in some cases at a premium to intermediate bond yields. Depressed stock prices are attracting corporate and private equity suitors, as capital is available for investment. In the absence of clear strategic direction, we have found that companies are repurchasing shares while maintaining balance sheet stability.

<sup>1</sup>Yield spread is the difference between yields on securities of the same quality but different maturities or the difference between yields on securities of the same maturity but different quality.

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Larry Weissman,  
Portfolio Manager

18 years of investment  
experience



Susan Kempler,  
Portfolio Manager

15 years of investment  
experience

## Investment Discipline: Equity—Mid Capitalization Core

### Market Update

In our opinion, the economy continues to stabilize and we are seeing evidence of a muted domestic recovery. Positive operating leverage—a company’s ability to grow revenues without growing expenses—is swinging the pendulum toward strong earnings growth, as even slow growth in revenues is being translated into surprisingly strong earnings. We expect to see continued strong earnings growth and believe there will be upside surprises when second quarter earnings are reported. Consumer confidence, business confidence and capital spending have all begun to improve and we believe that earnings growth expectations for the next few quarters should not be difficult to achieve and may even be surpassed.

For the quarter, the S&P MidCap 400 Index<sup>2</sup> increased by 17%, while the S&P Small Cap 600 Index<sup>3</sup> increased by 20% and the S&P 500 Index<sup>4</sup> gained 15%. The sectors that showed the best performance during the quarter were the most economically sensitive ones, such as Telecommunication Services, Information Technology and Consumer Discretionary, all up nearly, or just over 20% for the quarter. (Source: Baseline)

We expect to see continued positive implications longer-term as fiscal and monetary stimulus (Federal spending, interest rate reductions and anticipated tax cuts) should bolster the economy. With interest rates at historic lows and the corporate profit outlook improving, we remain optimistic about the market over the next few quarters.

### Strategy

With our constructive outlook on the market, we have continued to reduce cash levels in our accounts. Since we have just gone through an environment in which credit spreads<sup>5</sup> have narrowed dramatically and the domestic economy has finally showed some signs of stabilization, it is not surprising that equity market performance has improved. It is also important to note that the quarter did have a performance bias towards smaller capitalization and higher-risk companies that tend to exhibit higher operating leverage. We believe that this bias has largely run its course and we should start to see a relative improvement in the performance of higher quality stocks. Going forward, in an environment with an increasing focus on dividends and dividend-paying ability, and the potential for a dramatic increase in merger and acquisition activity, we believe that our consistent emphasis on companies with solid cash flows and strong or improving balance sheets should be well rewarded.

<sup>2</sup>The S&P MidCap 400 Index is a market-value weighted index consists of 400 domestic stocks chosen for market size, liquidity, and industry group representation. An investor cannot invest directly in an index.

<sup>3</sup>The S&P SmallCap 600 Index is a market-value weighted index, which consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation. An investor cannot invest directly in an index.

<sup>4</sup>The S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Please note that an investor cannot invest directly in an index.

<sup>5</sup>Credit spread is the difference between the yield of a particular corporate security and a benchmark security that has the same maturity as that particular corporate security.

We continue to employ a defined methodical approach in managing the mid-capitalization investment portfolio. We believe our sector-diversified, actively managed portfolio emphasizing stock selection can continue to offer consistent performance, while managing the risk profile of an investment in the mid-capitalization equity class. We have been actively trading around our core positions to try to take advantage of short-term market volatility and to attempt to enhance performance in what continues to be a low nominal growth environment. We have also made an effort to increase the concentration in the portfolios by reducing the number of holdings as our perception of market risk comes down and our conviction levels increase.

We look for companies with well-articulated objectives and strategies, long-term viable business models and successful historical execution. We focus on a thorough understanding of company fundamentals, seeking to create an information advantage and enhance the potential for superior returns. We believe companies possessing strong balance sheets, generating healthy cash flows with recognized franchise positions will be well positioned to drive shareholder value in various ways, including reinvestment of cash flow, within their existing business, acquisitions, share buybacks or dividends.

## Outlook

The mid-capitalization asset class has been the best-performing asset class over the last five-year period,<sup>6</sup> and we believe that the favorable comparison of lower valuation and faster and more consistent earnings growth versus large-capitalization stocks will continue to draw investor interest to this equity class. With interest rates at historically low levels and future growth deeply discounted due to investors near-term concerns, we feel that the mid-cap sector has the potential to benefit from an increase in merger and acquisition activity and investors' renewed focus on growth. We believe that well-positioned and conservatively financed mid-capitalization companies offer a relatively compelling investment opportunity as a part of a diversified portfolio.

<sup>6</sup>While the asset class may not have outperformed in other time periods, the cumulative performance for the five-year period from 6/30/98 to 6/30/03 the S&P MidCap 400 Index returned 33.36%. In comparison, the S&P 500 Index returned -14.05%, the S&P SmallCap 600 Index returned 15.37% and the Nasdaq Composite Index returned -14.35% for the same period. For the most recent one-year period, from 6/30/02 to 6/30/03, the S&P 400 MidCap Index returned -1.90% while the S&P 500 Index returned -1.55%, the S&P SmallCap 600 Index returned -4.47%, and the Nasdaq Composite Index returned 10.91% for the same period. Please note that an investor cannot invest directly in an index. The indices are for illustrative purposes only and do not represent past or future performance of any specific fund or investment option. The figures assume reinvestment of dividends and do not reflect any fees, expenses or tax consequences.

**INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE**

### Past performance is no guarantee of future results.

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