International Portfolio Review & Outlook

Foruth Quarter, 2010

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From: The Portfolio Management Team

Performance Review

The MSCI EAFE Index gained 6.6% in the fourth quarter as renewed confidence in the global recovery lifted markets. Foreign exchange movements and the Eurozone's sovereign debt crisis helped the Pacific region (+10.6%) outperform Europe (+4.5%). In local currency terms, the EAFE gained 5.6%, but a weakening Dollar added another 1.0% to U.S. investors' returns. Although the U.S. Dollar strengthened versus the Euro and UK Pound by 2.1% and 2.7% respectively, it weakened against the Yen and Australian Dollar by 2.4% and 5.0% respectively.

Our international portfolios outperformed our benchmark, the MSCI EAFE. Stock selection in the Financial and Consumer Staples sectors were the primary contributors to our relative performance. From a regional perspective, our holdings in Europe helped, while our relatively low allocation to Japan and our holdings in the Industrials and Materials sectors detracted from our returns.

Investment Outlook

Looking forward in 2011, we expect modest economic growth in the developed world driven by industrial strength and building momentum in the consumer sectors. Relatively high unemployment in much of Europe and Japan and continued policymakers' vigilance are likely to hold back core inflation pressures. We think the primary risk to equity markets is more restrictive monetary policy. As economic growth normalizes, withdrawing monetary stimulus without threatening the recovery is likely to present a challenge. Macroeconomic instability could lead to more volatility, but valuations look reasonably attractive. The MSCI EAFE's 2.9% dividend yield and its 12x price to earnings ratio are about 20% and 30% less expensive than fifteen-year averages. Inexpensive valuations, low inflation, and moderate economic growth traditionally add up to a favorable equity environment.

Europe

In November, Ireland became the second Eurozone country to require a bailout in 2010. The European Union and the International Monetary Fund committed €85 billion, of which nearly 60% is allocated to support the Irish banking system. The Irish government's decision to guarantee the debt of Irish banks, which are suffering from a property market crash, threatened the solvency of the whole country. The bank bailout added approximately 20% of GDP to the Irish budget deficit and to the government's gross debt, estimated to be 32% and 99% respectively for 2010. The decline is remarkable considering that in 2007 the Irish government's budget was in balance, and its debt was only 25% of GDP.

Market Index Returns

	4th Qtr. 2010	Year 2010	Year 2009
MSCI EAFE	6.6%	7.8%	31.8%
MSCI Europe ex. UK	3.7%	1.6%	32.6%
MSCI United Kingdom	6.0%	8.8%	43.3%
MSCI Japan	12.1%	15.4%	6.3%
MSCI Pacific ex. Japan	8.3%	16.9%	72.8%
MSCI Emerging Markets	7.3%	18.9%	78.5%

Portugal is widely picked as the next victim of the bond market contagion, yet Spain is by far the most important of the troubled Eurozone countries. The Spanish economy is the fifth largest in the Eurozone and is twice as large as the sum of the Greek, Irish, and Portuguese economies. Spain shares some characteristics with Ireland. The country's fiscal house looked in order prior to the crisis, but its banks are under intense pressure after funding a real estate bubble. However, the Spanish central bank practiced prudent management, including requiring extra reserves during the boom years, which could help them weather the storm.

We expect that if the situation deteriorates, European policymakers would dramatically expand their emergency funds to ensure Spanish stability. In our opinion, Europe's support of troubled peripheral countries largely reflects its will to maintain the monetary union and broad-based European integration. However, the prospect of European banks realizing losses on other countries' bonds is likely part of the political calculation. British banks are collectively Ireland's largest creditor and about half of Spanish debt is held by foreign creditors. In our view, it is important for Germany, the region's strongest economy, to impress upon its citizens the negative repercussions that a sovereign default could impart on its lenders and its economy. Compared to the MSCI EAFE, we are underweight the Eurozone and UK and overweight Switzerland. We continue to look for European stocks with exposure to relatively strong geographies and markets.

Japan

Japan's rapidly aging population poses serious challenges for its fiscal future. The number of people aged 65 and older is more than 35% of the number of people aged 15 to 64. This dependency ratio is important because the elderly typically draw on public resources, while the labor force funds social safety nets. Italy and Germany have the next oldest populations, with 31% dependency ratios, while the U.S., UK, France, and Canada are all at or below 26%. Yet despite these long-term pressures and an estimated budget deficit of 7.4% in 2010, Japan recently announced it will reduce its corporate tax rate from 40% to 35%. Japan's rate will still be about 5% higher than the German and British corporate tax rates, but those countries levy 20% value-added taxes, which are four times as high as Japan's comparable consumption tax. Japanese policymakers are presumably focused on generating more growth in order to reduce their debt, which is more than 200% of its GDP, and deficit burdens. The currency and bond markets don't appear worried about Japan, as the Yen strengthened 12% compared to the Dollar in 2010 and Japanese long-term bond yields remain the lowest in the world. We are concerned about the country's growth prospects and therefore mostly avoid investing in domestically-oriented Japanese stocks.

Asia Pacific and Emerging Markets

Emerging economies are currently contending with the potential for excessive growth. In Asia and Latin America, consumers and businesses are boosting demand for a wide range of products creating inflationary pressures. Chinese consumer price changes recently breached 5%, and unofficial inflation estimates are closer to 10%. To help the less-skilled segments of its population cope with rising costs of living, Beijing recently increased its minimum wage by 21% on top of a similar increase this past summer. And to rein in rapid credit expansion, the People's Bank of China raised interest rates by 0.25% twice in the past two months. We are relatively optimistic on China's ability to manage its growth, and we continue to seek companies that are benefitting from the secular growth in emerging market consumption.

Portfolio Activity

During the quarter, we added to our exposure to the Financial and Consumer Discretionary sectors in Asia and Latin America. We purchased Capitaland, a real estate developer and operator based in Singapore that owns a mix of residential, retail, office, and hotel properties located mostly in Singapore, China, and Australia. It has made a commitment to achieve LEED Gold certification for all new developments. Capitaland looks attractively valued based on its 20% discount to Net Asset Value estimates. We also initiated a position in Gafisa, one of Brazil's leading homebuilders, which is increasingly focusing on the lower income segments of the market. Urbanization, family formations, and income growth are supporting demand for housing that substantially exceeds supply in Brazil. Gafisa's price to earnings ratio of 9x looks compelling to us.

Company Spotlight

Vodafone Group Plc
Description Vodafone is one of the largest mobile telecommunications companies in the world. The company sells voice and data services to consumers and corporate customers. Geographically, reported revenue is generated in Europe (67.5%), Asia (14.5%), and Africa/Middle East (18%). In addition to these geographies, Vodafone has a 45% stake in U.S.-based Verizon Wireless, which is not consolidated in its financial results.
Investment Thesis Vodafone is likely to benefit from solid growth in wireless data and stabilizing voice revenues in Europe. Emerging market businesses in India, Egypt, and South Africa should also boost Vodafone's growth profile. The company's stake in Verizon Wireless is a highly valuable asset that should accelerate Vodafone's free cash flow generation. Trading at 10x earnings and a sustainable 4.8% dividend yield, Vodafone looks attractively valued. In our view, regulatory changes and intensifying competition are the company's primary risks.
ESG Profile Vodafone has set a goal of halving its operational CO^2 emissions by 2020 compared to 2007. The company is working with suppliers to procure the most energy-efficient network equipment, and its default option for cooling new base stations is fresh air as opposed to air-conditioning. Vodafone has introduced products specifically targeted at extending mobile service in emerging markets and rural areas through a combination of network expansion, development of low-cost handsets, and targeted applications like mobile money transfer.

Company examples are drawn from model portfolios using Boston Common's comprehensive social screens. Holdings may vary by portfolio due to customized account features. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that the securities discussed herein will remain in the account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. As with any investment, there is a risk of profit or loss.