

# Quarterly Perspective

For the period ending June 30, 2010

## China's Growth Opportunity Persists – and Current Environment May Enhance Opportunities

With China's stock market down roughly 20 percent this year, it's only natural to question the Asset Strategy composite's continued investment positioning in China, particularly amid the recent global equity volatility tied to southern Europe's sovereign debt crisis.

For several reasons, despite the market's downturn, our view on China hasn't changed. In fact, the decline in equity prices has expanded investment opportunities, as valuations on many stocks appear more attractive to us than they did just a few months ago. At the same time, China's policy steps in recent months have confirmed our confidence in the country's growth sustainability.

Given the recent global volatility, it's important to reiterate that we maintain a long-term investment view. With that view, day-to-day market volatility takes a backseat to actions we think will produce the best long-term investment results. And our view remains that investing in Asia, an area of burgeoning growth with 2/3 of the world's population, offers the world's best long-term investment opportunity. As a result, we maintain a significant structural overweight in China, one that differentiates us from many of our competitors in the global asset allocation space.

**Factoring Policy Risk.** We would

## Composite Performance Report

(as of June 30, 2010)

	2Q10*	Annualized Total Returns			
		1 Year	3 Years	5 Years	10 Years+
<b>Domestic Equity</b>					
Core Equity Gross <sup>1,2</sup>	-10.52	17.11	-5.87	2.52	0.96
Core Equity Net <sup>1,2</sup>	-10.67	16.43	-6.45	1.91	0.35
S&P 500 <sup>7</sup>	-11.43	14.43	-9.81	-0.79	-1.59
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Small Cap Growth Gross <sup>1,3</sup>	-8.29	17.09	-4.26	2.40	2.01
Small Cap Growth Net <sup>1,3</sup>	-8.50	16.15	-5.08	1.54	1.16
Russell 2000 Growth <sup>8</sup>	-9.23	17.94	-7.57	1.11	-1.73
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Large Cap Growth Gross <sup>1,4</sup>	-12.47	7.80	-4.54	1.92	-1.00
Large Cap Growth Net <sup>1,4</sup>	-12.62	7.15	-5.13	1.31	-1.60
Russell 1000 Growth <sup>8</sup>	-11.75	13.62	-6.91	0.38	-5.14
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<b>Domestic Fixed Income</b>					
Core Gross <sup>1,5</sup>	3.63	8.29	8.62	6.30	6.85
Core Net <sup>1,5</sup>	3.56	7.97	8.31	6.00	6.54
Citigroup Broad Inv Grade <sup>9</sup>	3.67	9.03	7.95	5.77	6.61
<hr/>					
Core Intermediate Gross <sup>1,6</sup>	3.00	7.69	8.07	6.08	6.44
Core Intermediate Net <sup>1,6</sup>	2.94	7.44	7.82	5.83	6.19
Citigroup Govt/Corp 1-10 Year <sup>10</sup>	3.09	8.41	7.12	5.36	6.13

\* Actual return from April 1, 2010 through June 30, 2010.

+ These returns are presented as supplemental information to the returns required by the GIPS® Advertising Guidelines.

Past performance is no guarantee of future results. Returns are presented on a dollar-weighted basis and may be impacted by ongoing market volatility. Please inquire for more current performance information.

characterize the latest global equity retreat as a "growth scare," as opposed to the beginning stages of another global recession. We think the volatility primarily has reflected questionable secular policy decisions in some developed markets. While we feel the corporate side of the economic equation has responded well to the global financial crisis of 2008-09 – with companies generating substantial cash in the process – policy makers continue creating volatility risk.

The global market's downturn in early May began when the European Central Bank did not make clear its intentions regarding the manner in which it might address debt problems in Greece, Spain and Portugal. To a smaller degree, the lack of policy clarity regarding financial institution reform and other issues in the U.S. also creates uncertainty for global markets.

Quite frankly, China's policy makers have reacted in ways that

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## China's Growth Opportunity Persists – and Current Environment May Enhance Opportunities

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make a lot more sense to us than their counterparts in the U.S. and Europe. Consequently, the potential for a policy mistake currently appears higher in the U.S. and Europe than China.

It appears China's central government officials have learned from past policy mistakes, such as their decision to raise interest rates heading into the global financial crisis. Heading into 2010, China anticipated continued economic growth as the result of increased consumption and fixed asset investment. It did not expect substantial export growth as the global economy continued recovering in a muted fashion. However, China's export growth has surpassed expectations, and the central government's fixed asset investments pushed property prices in large cities substantially higher. The result: the country's economy began overheating.

The central government reacted not by raising rates, but by tightening on the edges. It scaled back its fixed asset initiatives, and property transaction volume virtually has halted. Fears of a property price bubble have eased; with transaction volume down, prices should follow. In addition, inflation – a constant concern of investors in China – likely will peak at 4 percent within the next two months we believe.

**Pullback Creates Opportunities.** Nonetheless, because of China's tightening measures and worries about property prices, investors in China's market essentially have priced in a recession, even though we anticipate the country's gross domestic product to rise by 8-9 percent in the last half of 2010. In spite of the broad market's view, China's economy continues growing at a consistent pace, and consumption remains stable.

Meanwhile, the slide in China's stock prices has pushed valuations almost to the levels last seen during the trough of the global financial crisis 18 months ago. At June 16, Hong Kong's Hang Seng Index was trading at 1.67 times book value, a level that traditionally has provided good investment value.

In short, given the economic outlook and current valuations, we believe that China presently offers an appealing risk/reward tradeoff.

With the current environment offering what we feel are good opportunities in a part of the world that we think offers the best long-term global growth prospects, an overweight in China appears justified. We're attentive about reassessing the position should conditions change. If, for instance, the GDP growth outlook fell considerably, we would reduce our weighting in China.

But for now, the key factors – China's policy vigilance, its attractive valuations, its long-term growth prospects – all argue in favor of continued investment allocation to firms that may be benefiting from China's growing economy. ■

*Past performance is not a guarantee of future results. The opinions expressed are those of the Asset Strategy composite portfolio managers and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through June 16, 2010, and are subject to change due to market conditions or other factors.*

*International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Because the composite may concentrate its investments, the composite may experience greater volatility than an investment with greater diversification.*

## Mid-Year Outlook: Global Recovery Continues, Moderates

The global economy has played out as we expected up to this point. Emerging market economies continue to be strong, though some are showing signs of slowing. The developed world still shows positive growth. Economic growth in the United States seems to be slowing as we start the second half of 2010. European growth continues to be mixed, with core countries such as Germany doing relatively well while countries such as Greece remain weak. Given that, here's our outlook for the next six months.

Emerging market economies should continue to grow at a healthy clip. Chinese growth has begun to slow in response to efforts by policymakers to intentionally reign in growth. Gross domestic product was roughly 12 percent on a year-over-year basis in the first calendar quarter of 2010, and is likely to slow to around 8 percent by the end of the year, which is a slower but more sustainable level. If the Chinese economy slows more than expected, the government will most likely ease up on policy in an effort to reaccelerate growth. Other parts of Asia and Latin America continue to experience solid growth, while policy makers have started to tighten policy, albeit at a cautious pace. Inflation pressures in emerging markets have risen and likely will peak on a year-over-year basis in the next few months.

In general, developed markets are showing positive growth. In the United States, gross domestic product growth has slowed from more than 5 percent on an annualized basis in the fourth quarter of 2009 to an expected 3 to 3.5 percent in the second quarter of 2010. Waning government stimulus will likely be a drag on growth, resulting in slower growth in the second half of 2010. However, as corporations are flush with cash and are running lean, we believe that significant weakness resulting in recession likely will be avoided. Consumer spending should continue to grow, albeit at a muted pace. Employment gains have been disappointing thus far, but we expect continued gradual improvement going forward. Housing remains a drag on the economy and is unlikely to be a growth vehicle in the foreseeable future.

European core countries, especially Germany, continue to benefit from the global upswing. Strong emerging-market growth coupled with a weaker exchange rate means that the German manufacturing base is quite strong (data through May shows orders for German manufactured goods are up 25 percent year-over-year, albeit from a low base). Eurozone countries have begun to implement austerity measures that will be a drag on growth, especially in the periphery (Greece, Spain and Portugal). After a change in government, the United Kingdom is

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### About Waddell & Reed

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### Assets Under Management

#### Institutional Assets as of 6/30/10

Equity	\$6,182.3 mil
Fixed Income	766.3
Balanced	<u>693.4</u>
<i>Total</i>	<i>\$7,642.0 mil</i>

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## Mid-Year Outlook: Global Recovery Continues, Moderates

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now embarking on an aggressive austerity plan as well, cutting government spending and raising taxes. However, even relatively austere countries such as Germany are cutting budget deficits, although less than we are seeing elsewhere. Thus, European growth is likely to continue to underperform most of the world.

In developed markets outside of the United States and Europe, Japan has returned to positive growth, helped mainly by exports. Resource-based countries such as Canada and Australia have benefited from higher commodity prices, low government debt, unimpaired banking systems and strong domestic demand. Central banks in both Canada and Australia have begun to raise rates given the relatively strong growth. We feel that both countries are likely to continue to outperform the developed world.

Concerns have been rising recently about a “double-dip” recession, particularly in the developed world, based on the experience of the United States in the late 1930s. While that scenario is not impossible, we believe economic growth should continue to expand at a moderate pace. U.S. corporations have a lot of cash on hand. Inventories are not excessive and up to this point, corporations haven’t markedly increased spending on capital expenditure and employment, if at all. Thus, the risk of cuts in any of these areas is minimal. As we stated earlier, Europe should see modest growth, with core countries like Germany offsetting weakness in the periphery.

Confidence is key here, as a lack of confidence could prevent corporations from spending. A lack of corporate spending will likely prevent the start of a virtuous circle, whereby corporations spend and hire new employees, which increases wages and consumer spending, which then increases revenues for corporations. Any hit to confidence, which most likely would be in the form of public policy mistakes, would be harmful.

One issue we continue to focus on is the size of sovereign debt and the need for governments to

deleverage. As Europe goes through this adjustment, the public sector of the economy will be a significant drag on growth for several years. Yet this is not only a problem in Europe. The United States likely will go down this path relatively soon. If no changes are made, current trends point to government debt equaling the size of the U.S. economy in the next few years (i.e., debt to gross domestic product of 100 percent). The United States will need to address this problem. However, one risk to global growth is an environment in which most governments are tightening their belts at the same time. This is definitely a headwind going forward, but is an adjustment that needs to be made nonetheless.

In summary, we continue to look for modest global growth going forward. In developed markets, the tailwind of government spending over the last few years will become a headwind, thereby limiting growth rates in the short-term. Emerging market economies will continue to perform well, as policy makers are careful to not be too aggressive in tightening measures. Overall, the global recovery should proceed at a moderate pace. ■

*Past performance is not a guarantee of future results. The opinions expressed are those of Derek Hamilton, Waddell & Reed Investment Management Company global economist, and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through July 2010 and are subject to change due to market conditions or other factors.*

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### **Waddell & Reed Asset Management Group**

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## Additional Quarterly Perspective Information

Waddell and Reed Investment Management Company ("WRIMCO" or the "Company") is an investment adviser registered with the Securities and Exchange Commission ("SEC") that provides investment management and advisory services to institutional separate accounts over multiple investment styles. WRIMCO is a subsidiary of Waddell and Reed, Inc., a subsidiary of Waddell and Reed Financial Services, Inc., a subsidiary of Waddell and Reed Financial, Inc. Certain officers and investment staff of WRIMCO also hold offices with Ivy Investment Management Company ("IICO"), another investment adviser registered with the SEC that is also a subsidiary of Waddell and Reed Financial, Inc., with minimal separate account responsibilities.

For purposes of compliance with the Global Investment Performance Standards ("GIPS®"), the Company has defined the firm as all institutional separate accounts managed by WRIMCO and IICO.

To receive a complete list and description of Waddell and Reed Investment Management Company's composites and/or a presentation that adheres to the GIPS® standards, please call 1.877.887.0867 or visit <http://www.institutional.waddell.com>.

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<sup>1</sup> Annual returns reflect yearly changes with all dividends and other earnings reinvested. Returns shown gross of fees reflect commissions paid, but are gross of all expenses. A client's returns will be reduced by investment management fees and other expenses incurred in the management of a client's account. Returns shown net of fees reflect all advisory fees, commissions and other expenses a client would have paid based on the minimum account size for the style. This results in the largest possible expense ratio in the calculation. Larger accounts will generally have a lower associated expense ratio. Waddell & Reed Investment Management Company's (WRIMCO) standard fee schedule for institutional advisory accounts is provided in Part II of WRIMCO's Form ADV. Past performance is no guarantee of future results. Investment returns and the actual value of each client account will fluctuate, and at any given time an account could be worth more or less than the amount invested. The benchmark selected for each composite is intended to provide a method to compare the composite's performance to an index including securities that are generally similar to those that are included in the composite. However, composite holdings (and, accordingly, risk and volatility) may differ significantly from the securities tracked by their benchmarks.

<sup>2</sup> Core Equity composite is comprised of 12 separately managed institutional accounts that had \$325.4 million in total assets as of 6/30/10. The assets included in the composite represent 4.3% of the total institutional assets under the management of Waddell & Reed Investment Management Company (WRIMCO) and its investment management affiliate. One of the accounts in this composite is managed by an affiliate of WRIMCO with common portfolio management. The Core Equity composite invests in a portfolio of high quality, large cap securities that have the potential for capital growth or that may be expected to resist market declines. The composite employs a top-down rotational strategy with a fundamental approach to stock selection. The Company's Core Equity composite includes all fee paying, discretionary portfolios managed following the firm's Core Equity discipline. The composite was created on March 28, 2005. The performance presentation is in U.S. dollars.

<sup>3</sup> Small Cap Growth Equity composite is comprised of 25 separately managed institutional accounts that had \$1,231.5 million in total assets as of 6/30/10. The assets included in the composite represent 16.1% of the total institutional assets under the management of Waddell & Reed Investment Management Company (WRIMCO) and its investment management affiliate. The Small Cap Growth composite focuses on the diversified selection of high quality, small capitalization growth companies. The primary objective of the composite is to achieve maximum capital appreciation via the selection of companies with above average profitability characteristics and earnings growth. The Company's Small Cap Growth composite includes all fee paying, discretionary portfolios managed following the firm's Small Cap Growth discipline. The composite was created on March 28, 2005. The performance presentation is in U.S. dollars.

<sup>4</sup> Large Cap Growth Equity composite is comprised of 41 separately managed institutional accounts that had \$3,897.5 million in total assets as of 6/30/10. The assets included in the composite represent 51.0% of the total institutional assets under the management of Waddell & Reed Investment Management Company (WRIMCO) and its investment management affiliate. Six of the accounts in this composite are managed by an affiliate of WRIMCO with common portfolio management. The Large Cap Growth composite focuses on the diversified selection of high quality, large capitalization growth companies with sustainable competitive advantages. The composite takes a consistent approach to achieving capital appreciation by creating a diversified portfolio of companies with superior long-term profitability characteristics. The Company's Large Cap Growth composite includes all fee paying, discretionary portfolios managed following the firm's Large Cap Growth discipline. The composite was created on March 28, 2005. The performance presentation is in U.S. dollars.

<sup>5</sup> Core Fixed Income composite is comprised of 10 separately managed institutional accounts that had \$508.2 million in total assets as of 6/30/10. The assets included in the composite represent 6.7% of the total institutional assets under the management of Waddell & Reed Investment Management Company (WRIMCO) and its investment management affiliate. The Core Fixed Income composite seeks to attain a high level of current income through the selection of investment grade fixed income instruments with a duration of 80% - 120% of the benchmark index. This is accomplished primarily through sector-emphasis and individual issue selection based on the continual monitoring of the economic environment, interest rate trends, industry fundamentals and the features of individual securities. This style is characterized by high credit quality, call protection, wide diversification and low exposure to event risk. The Company's Core Fixed Income composite includes all fee paying, discretionary portfolios managed following the firm's Core Fixed Income discipline. The composite was created on March 28, 2005. The performance presentation is in U.S. dollars.

<sup>6</sup> Core Intermediate Fixed Income composite is comprised of 3 separately managed institutional accounts that had \$18.5 million in total assets as of 6/30/10. The assets included in the composite represent 0.2% of the total institutional assets under the management of Waddell & Reed Investment Management Company (WRIMCO) and its investment management affiliate. The Core Intermediate Fixed Income composite seeks to attain a high level of current income through the selection of investment grade fixed income instruments with a duration of 80% - 120% of the benchmark index. This is accomplished primarily through sector-emphasis and individual issue selection based on the continual monitoring of the economic environment, interest rate trends, industry fundamentals and the features of individual securities. This style is characterized by high credit quality, call protection, wide diversification and low exposure to event risk. The Company's Core Intermediate Fixed Income composite includes all fee paying, discretionary portfolios managed following the firm's Core Intermediate Fixed Income discipline. The composite was created on March 28, 2005. The performance presentation is in U.S. dollars.

<sup>7</sup> S&P 500 Index data has been derived from Vestek Systems, Inc.

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<sup>9</sup> Citigroup Broad Investment Grade Index data has been derived from Vestek Systems, Inc.

<sup>10</sup> Citigroup Govt/Corp 1-10 Year Index data has been derived from Vestek Systems, Inc.