

***Investing in Water Stocks – A Diversified & Global Theme for the 21<sup>st</sup> Century***

The global water business is finally receiving the attention that has been long overdue—from governments, industry, financial institutions, investors and a growing global population. The concern for water use and reuse has become an everyday topic. The size of the global water market has been estimated to be between \$425 billion to almost \$700 billion yearly by such sources as Global Water Intelligence and private consultants. That is the cost of maintaining the infrastructure that we have today. What will the cost be in the future?

In the U.S. there is very little concern for water conservation. Why should there be? Water here is cheap, plentiful, and clean. Plainly stated, water is taken for granted. While the United States and most of Europe have long enjoyed an ample supply of fresh potable water, the global situation continues to worsen in Africa, the Middle East and Asia—especially China and India. The U.S. only accounts for approximately 25% of the global spend on water...so where is the other 75% being spent?

While most global discussions seem to revolve around global warming and the inevitable impacts during the 21<sup>st</sup> century, the reality is that water *is* the immediate concern that deserves our attention. While the verdict on global warming will continue to be debated, we believe there are more imminent issues—lakes are shrinking more rapidly, shoreline erosion is more prevalent and is, in fact, accelerating, and the depletion of rivers is inescapable.

Typically, we tend to reflect on needs and scarcity in times of hardship. Over the last quarter century, the United Nations, The World Bank and various independent think tanks have lead a quiet but forceful cry that went unheard until consecutive cataclysmic events, such as the Sumatran Tsunami and Hurricane Katrina, occurred. Add the monthly water contamination events that seemed to dominate China over the last year and the mounting news of corporate irresponsibility concerning the pollution of existing water supplies, and one has to strongly reflect on the state of the global water sector and the impact it is having.

Solutions to the aforementioned problems are provided by a diversified group of global, publicly traded stocks that focus on the world's need for safe, clean drinking water and acceptable sanitation levels. For investors, the global water industry may provide a significant investment opportunity for the foreseeable future.

<b>Growth Rates - Water</b>	<b>Growth in 2007</b>	<b>Growth through 2010</b>
United States	4-6%	5-7%
China	15%	15-20%
Developing Countries	20%	20%

\*Estimates provided by Aqua Terra Asset Management LLC

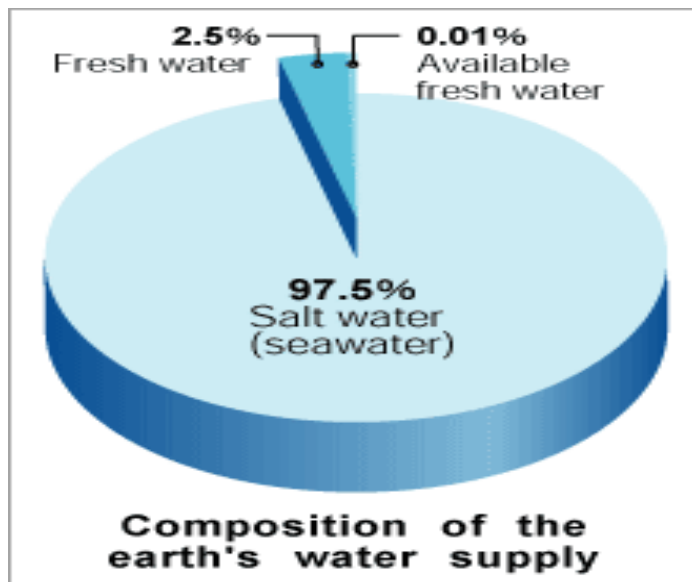
**The Ultimate “Shrinking” Commodity - Water Availability vs. Population Growth**

As a commodity, we believe water is the least appreciated investment compared with precious metals, oil, timber, and other natural resources. It is the one commodity where demand is typically not subject to the pressures of macroeconomic issues—namely, inflation, interest rates, war, recession/depression or the ever-fickle consumer who is always looking for the next best thing. Water cannot be duplicated, nor cannot be created in a laboratory or manufactured from substituted elements.

From the beginning of the existence of the earth, water has existed in a finite state with no new source introduced over the last 10 million years. Available water is less than 1% of all water on the planet while the renewable supply has fallen by almost 60%. Only 20% of the global population has access to running water, according to numerous estimates.

There are just over 6.1 billion people on the planet as of 2007, but census officials predict there could be as many as 9 billion people by 2050. In our view, within 50 years more than half of the entire global population will be living with water shortages affecting 80 countries, including the United States. And more demand for water means that the already under-supplied resource will become scarcer in the years to come.

The World Bank has stated that global demand for water is doubling every 21 years. And, at present, 1 billion people on the planet don't have access to safe water. Over 1.1 billion people do not have access to adequate water supplies. According to the World Health Organization (WHO), water is "implicated in 80% of all sickness and disease worldwide."



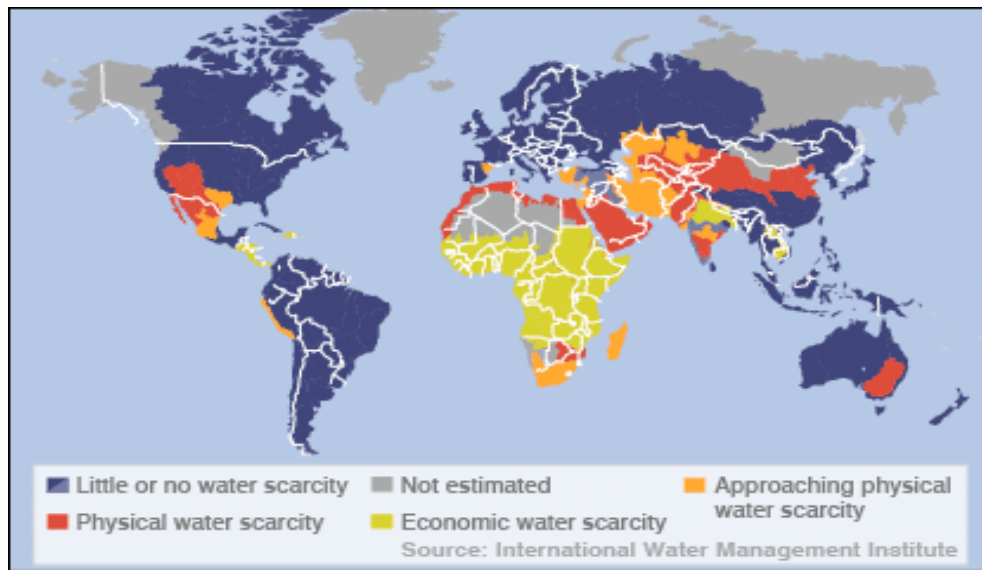
Source: OMSOLAR.NET

If the world's water were compressed into a single gallon, only 4 ounces would be fresh. Of that, only two drops would be easily accessible and only one of which would be for human use.

**Water Scarcity - The Two-Edged Sword**

There are two types of water scarcity that we have identified—economic scarcity and physical scarcity. Plainly stated, physical scarcity occurs when the water resources cannot meet the demands of the population while economic scarcity occurs due to a lack of investment and is characterized by poor infrastructure and unequal distribution of water.

## WHERE WATER IS SCARCE



Source: BBC

While the two types of scarcity have a profound impact on the way water usage is managed, some facts have come to light that have physical and economic ramifications:

### *Shrinking Resources*

- The Dead Sea has dropped more than 66 feet in the past 100 years and is now losing about 3 feet each year.
- Lake Chad in Africa is now 1/20 the size it was 35 years ago.
- Mount Kilimanjaro has lost 75% of its ice cap...and it could lose ALL of its ice by 2020 (Time Magazine).
- Groundwater levels in densely populated areas such as North China, India and Mexico are declining rapidly due to overexploitation.
- As of the end of 2006, 95% of the world's cities continue to dump raw sewage into rivers and other freshwater supplies, making them unsafe for human consumption.

### *Country-Specific Events*

- In China, 449 cities currently suffer water shortages, 110 of which have reached critical levels.
- In India the country has drilled over 21 million wells that now pull over 200 cubic kilometers of water out of the earth—well short of demand.
- In mid-December 2005, the premiers of Quebec and Ontario, along with the governors of eight US states, signed a pact that will ban all large-scale water diversions from the Great Lakes basin. That will prevent 20% of the total fresh surface water of the Earth from being exported by pipeline to California, Arizona, or Nevada. The eight states that border the Great Lakes—Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin—are keenly aware of the value of adjacent surface water and the need to protect such sources for their own use.

*Global Warming Fears*

- Over the last 100 years the surface temperature of the Earth has risen 1 degree Fahrenheit. According to the Intergovernmental Panel on Climate Change (“IPCC”), if this trend continues, the earth could experience an additional 3 to 10 degrees Fahrenheit increase by the end of this century. The physical result is less inland snow, a reduced amount of fresh river water, drying aquifers, and intense strain on any ecosystem relying on irrigation, which accounts for 70% of all global water use.
- As ocean volumes cause coastal sea levels to rise, the contamination of freshwater sources along these coasts will occur.

*Water Shipment*

- With entire regions becoming unsuitable for crop production, a physical and economic scarcity will be triggered for both food and water, since water will be transported into the water-deprived nations, most likely by tankers.
- The export of fresh water by sea tankers already exists between France and Algeria and Turkey and Israel, according to Daniel Zimmer, World Water Council.

*Leveraging Technology*

- Water-stressed regions of the world will most likely have compulsory water metering as a mandatory requirement in the years to come. Almost 19 million people in the United Kingdom face compulsory water metering under plans outlined by the government in January 2007 to help tackle water shortages. The measures, outlined in a consultation paper from the Department for Environment, Food and Rural Affairs, encourage water companies in drought-prone areas to impose metering on customers.
- “Precision irrigation”—the efficient use of water to grow crops, especially in arid regions—will become a common phrase throughout the world.

Based on these two types of scarcity, the supply-and-demand aspects of water are far different from other commodities; while the water supply shifts to where the usage increases, the basic problems will continue to be physical location and existing and created contamination of water sources.

**So Where Do the Investment Opportunities Exist? Globally, of course!**

There are several themes that have emerged in the global water market that have investors focused on such areas as infrastructure, desalination, purification, transportation, etc., as well as the geographic themes of need of water infrastructure in China and the rebuild of the US water infrastructure.

We anticipate each of these themes has the potential to be profitable for investors. Investing in the water business is not a “get rich quick” activity. It takes patience, understanding, good stock selection and a bias toward value investing.

It also helps when the investment manager has had prior experience in water-related activities, environmental issues from engineering and operations standpoint, and a historical track record in water investing. Granted, it will be a rarity for individual and institutional investors to find all of the above but fortunately we collectively at Aqua Terra have had ample experience in all of these areas.

### Investing In United States

By U.S. Environmental Protection Agency (“EPA”) estimates, water is the single largest expenditure in the entire U.S. economy—behind only defense spending and Social Security. While the sheer expenditure numbers are staggering, investing in the water industry is a stock-by-stock case, carefully selecting companies that represent the many facets of the global water business. While it is natural to gravitate to water utilities at first, the companies that make up the 450 stock universe we cover mainly come from the following sub sectors: pipes, pumps, valves, chemical, filtration, instrumentation, engineering and infrastructure holding companies.

Domestic U.S. stocks account for approximately 25% of that universe; 105 companies in various sub sectors (ten of which are water utilities). While the historical valuations of U.S. water-related companies have seen considerable appreciation over the last five years, we remain encouraged that company specific opportunities exist from a value perspective.

### Spending in the Various Water Segments – United States

<b>Business Segment</b>	<b>2005 Revenue</b>	<b>2006-2008 Growth</b>
Water Treatment Equipment	\$9,110	6%-8%
Delivery Equipment	\$11,660	3%-5%
Chemicals	\$4,020	2%-3%
Contract Operations	\$2,350	6%-8%
Consulting/Engineering	\$7,460	5%-8%
Maintenance Services	\$1,780	4%-6%
Instruments & Testing	\$1,400	4%-6%
Wastewater Utilities	\$34,130	4%-6%
Drinking Water Utilities	\$35,070	3%-5%
<b>Total US Water Industry</b>	<b>\$106,980</b>	<b>4%-7%</b>

\*based on estimates from the Environmental Business Journal 2006

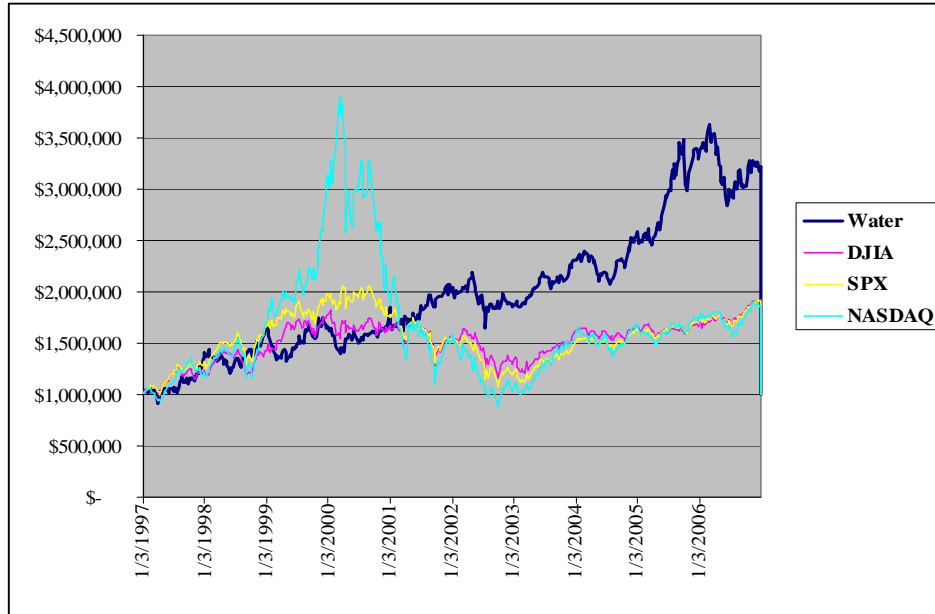
Specifically in the U.S., the ten publicly traded utilities represent the “buyer” of the goods and services of the approximately 95 companies that comprise our U.S. infrastructure universe. The unique characteristic of the water utilities is that they must provide a regulated, uninterrupted product to their customer base, leading to an uninterrupted buying cycle that provides an investor with the opportunity to purchase companies that have significant cash flow, high Return on Equity and are non-cyclical based on the macro conditions.

We anticipate water infrastructure investing in the U.S. should accelerate. The EPA has stated that at least 25% of the nation's pipes are “poor, very poor or elapsed.” That number is expected to increase by 45% by 2020. Over the next twenty years, the nations 54,000 water systems and 16,000 wastewater treatment facilities will face “staggering public investment needs.” According to the American Society of Civil Engineers (“ASCE”), the U.S. water infrastructure will require over \$1 trillion in repairs by 2025. It is estimated that the U.S. loses *60 billion gallons per day due to leaky pipes.*

For years, water investing was looked at as a “defensive” theme when the economy started to falter based on its sustainable cash flow and the guaranteed rate base increase of the utilities. As those rate base amounts have increased to meet the demand of the infrastructure rebuild here in the U.S., investors have transitioned the sector into a more “growth oriented” psychology that exists today.

This brings us to U.S. water utilities and their unique characteristics. In our opinion, most individual and institutional investors who have followed the water theme over the last ten years have a significant portion of assets in these companies. It is worth mentioning the merit of long-term investing in these stocks. In our view, performance and dividends have been the driving themes for these companies as they simplistically provide a demand-and-supply story that is unrivaled by any other sector. As Wall Street always looks to the future, water utilities have provided, in many cases, what investors desire most: consistency and predictability.

**10-Year Growth of a \$1 Million Investment**



\*The Water Utility Stocks are an equally weighted list of all publicly traded U.S. water utility stocks that existed as of 12/31/06 with dividends not included for any index. Importantly, this is a negatively selected list, in that returns on acquired companies included in the universe (typically purchased at large premiums) are not included. If the returns of all water utility stocks that were trading at the beginning of these periods had been included, the returns would have been substantially higher. The lists of securities that comprise this basket are available upon request. A direct investment in an index is not possible. Past performance does not guarantee or represent future returns.

Recently, investors have cooled to U.S. based water utilities, primarily due to expanding valuations. However, when we look at the long-term trends, there are several points that need to be taken into consideration and why U.S. Utilities at the proper valuations are still a core holding for the long term. In our opinion:

- First, the demand for water is and will most likely remain steady and accelerating. Water utilities are the sole source for the demand in a large demographic of the U.S. (the other being well water). Therefore, the water utilities are a monopoly in the regions they serve.
- Second, water cannot be redirected like other utilities, namely electric and gas. In the world of water, such shifts are uneconomical because water cannot be sold for more than the transportation costs. Water is prohibitively expensive to move over any significant distance due to the price.
- Third, mergers and acquisitions are likely to continue in the same manner. As previously stated, the EPA estimates U.S. water systems need hundreds of billions of dollars in upgrades and repairs. Many water systems are beyond the ability of local municipalities to finance repairs, leaving two options: 1) merge their systems with others; or 2) sell them to the investor-owned water utilities. Investor-owned water utilities are well financed, efficient and have an investment track record unsurpassed by other sectors. They are buying up these assets at cheap prices from cash-strapped municipalities. It may be an opportune time to buy, because, even accounting for the substantial investments needed, the buyer of the water system could be looking at good, consistent long-term returns.

- Fourth, and final... Rate base increases for the water utilities are likely to increase for the foreseeable future. As the cheapest utility that enters your home, we do not expect the Public Utility Commissions to halt the need for water infrastructure build outs at the sake of trying to cut or manage cost. It is what it is! Without deliverable water, you have anarchy. Conflicts on a regional basis have been fought over water and for some odd reason history has a way of repeating itself if not paid attention to—especially by government officials.

<b>Rolling Performance</b>							
<b>Water Index</b>	<b>1991 - 2000</b>	<b>1992 - 2001</b>	<b>1993 - 2002</b>	<b>1994 - 2003</b>	<b>1995 - 2004</b>	<b>1996 - 2005</b>	<b>1997 - 2006</b>
Annual Rate	14.7%	12.1%	10.8%	11.0%	14.3%	13.0%	12.4%
Cumulative	295.2%	213.5%	178.4%	183.6%	281.0%	240.5%	222.7%

<b>SPX (S&amp;P 500)</b>							
<b>Annual Rate</b>	<b>14.9%</b>	<b>10.7%</b>	<b>7.3%</b>	<b>9.1%</b>	<b>10.2%</b>	<b>7.3%</b>	<b>6.7%</b>
Cumulative	299.8%	175.3%	101.9%	138.4%	163.9%	102.7%	91.5%

<b>Russell 2000</b>							
<b>Annual Rate</b>	<b>13.8%</b>	<b>9.9%</b>	<b>5.7%</b>	<b>8.0%</b>	<b>10.0%</b>	<b>7.8%</b>	<b>8.1%</b>
Cumulative	265.8%	157.2%	73.3%	115.4%	160.3%	113.1%	117.2%

<b>MSCI</b>							
<b>Annual Rate</b>	<b>10.2%</b>	<b>6.5%</b>	<b>4.8%</b>	<b>5.6%</b>	<b>6.6%</b>	<b>5.2%</b>	<b>5.9%</b>
Cumulative	164.6%	87.4%	59.4%	73.2%	89.0%	71.3%	77.4%

\*The Composite of Water Stocks represents a basket of 6 publicly traded water utilities and 12 equipment manufacturers that had at least 20 years of business experience in the water industry. Comparison of portfolio returns is based on equal number of shares with simple price appreciation and no rebalancing. Returns do not reflect the reinvestment of dividends, interest and income. Past performance is not a guarantee of future results.

### Investing in China

Whereas the United States and Europe have enjoyed a developed water delivery system for decades if not several centuries, China is another story. No country in the world has a more acute water problem than China. The Peoples Republic of China ("PRC") has committed over \$128 billion in water infrastructure spending over the next five years.

China has over one fifth of the world's total population and just 7% of the fresh water on earth. The United Nations has identified China as one of the 13 countries with the lowest water per capita in the world. China's waters are so polluted they cannot support aquatic life, while the migration of individuals from the farming communities to the new industrial zones puts further stress on a country that suffers from both physical and economic water scarcity.

- It is estimated that half of China's population consumes drinking water contaminated with animal and human waste that exceeds permissible levels on a daily basis, and that 33% of the workforce in industrial zones have an excessive absentee rate due to water-borne pathogens.
- As Minister of Water Resources Wang Shucheng noted, "The price of China's economic boom is being paid in water." Two-thirds of China's 600 largest cities don't have enough water; half of these cities have polluted groundwater. Less than 15% of China's population has safe drinking water from a tap.

China has 7% of the world's water, equivalent to Canada, but a population 40 times as large. On a per capita basis, China's water reserves are only about one-quarter of the global average. Nearly half of China's population resides in the northeastern provinces, where only 14% of the water resources are located. China uses approximately 7–15 times more water than developed countries with its usable water supplies steadily diminishing. What does this mean to economic growth?

To sum up the parts, water solution companies that are domiciled in China, Singapore, Japan, Korea, etc., that have the advantage of cultural and geographical proximity to China will likely be the beneficiaries of an infrastructure build out that will be decades in the making. Also, European companies that have long enjoyed relationships with the PRC and have already penetrated the water sector in China are likely to leverage the relationship and domain knowledge of water specific issues into new contract awards.

### **The Middle East and Desalination**

The need for desalination will continue to expand, especially in arid regions like the Middle East. Presently the Middle East accounts for approximately 60% of all the desalination plants in the world while the Saudi Kingdom has 24% of the market. The United Arab Emirates ("UAE") is expected to spend \$7 billion by 2015. One little discussed fact is the largest desalination plant in the world is found in Ashkelon, Israel.

- With 700 plants presently in operation worldwide, the desalination market is anticipated to enhance expenditure of approximately \$95 billion.
- Just in the Middle East alone, approximately \$117 billion is expected to be invested between 2005 and 2015, an increase of 59% over the previous decade according to Gulf Capital.

The spending acceleration can be pegged to growth in populations, expanding economies and the need for large-scale spending on new water projects and an inadequate investment in the existing infrastructure. It is anticipated that the region—including Egypt, Iran, Iraq—will be required to invest heavily in the water infrastructure sector just to satisfy demand and avoid the potential for social and economical uprisings.

Some facts to consider in the Middle East:

- The amount of available renewable water per person in Middle Eastern and North African (MENA) countries is one-fifth of what it is in the rest of the world, and 80% of the countries fall below the international water scarcity threshold of 1,000 cubic meters (m<sup>3</sup>) per person per year.
- In addition, water coverage is limited. Potable water network coverage reaches an average of 75% of the population in MENA countries.
- However, many MENA countries have some of the highest water consumption rates per capita in the world. Consumption per capita in the UAE for example is among the highest in the world, standing at 570 liters per person a day, more than three times the world average. Seventy percent (70%)
- High consumption rates are mainly driven by aggressive agricultural policies, which sometimes account for more than 90% of a country's water usage. This is further accentuated by high technical and commercial losses in the water systems, also referred to as "UFW" for unaccounted for water, reaching in some places as high as 40-50%.

*Source: Booz Allen Hamilton*

**Canada**

Canada is one of the most water-rich countries in the world. In 2025, when 30% of the world's people face a water shortage, as is forecast by the Centre for Strategic and International Studies, none of them will be in Canada.

However, there is a lurking problem on the horizon with a number of water systems failing due to age and a wastewater issue on both coasts. The failure of Canadian water systems is due primarily to the age of the systems, a growing population that exceeds the capacity of the systems, poor management and ill-trained staff, lax regulation, and a lack of capital and operating funds, according to the Fraser Institute.

Canada's water and wastewater systems are in desperate need of investment. Estimates vary, in part because many municipalities lack accurate assessments of their infrastructure's condition. However the following estimates are presented:

- The National Round Table on the Environment and the Economy suggested in 1996 that, over the following 20 years, Canada would need to invest between \$38 billion and \$49 billion to maintain and refurbish existing water and sewage infrastructure.
- In addition, it estimated it would need to invest \$41 billion in new stock (National Round Table on the Environment and the Economy, 1996: 10, 35).
- The Canadian Water and Wastewater Association roughly echoed the Round Table's projections, estimating that, between 1997 and 2012, \$27.6 billion would be required to renew water treatment and distribution and \$61.4 billion would be needed to upgrade sewers and wastewater treatment (Canadian Water and Wastewater Association, 1998: iv).

Even Canada with its abundance of water cannot escape the reality that once the infrastructure is developed, the cost of maintaining it cannot be avoided or delayed.

<u>TOP TEN WATER RICH NATIONS</u>		<u>BOTTOM TEN WATER RICH NATIONS</u>	
1.	<i>Finland</i>	1.	<i>Haiti</i>
2.	<i>Canada</i>	2.	<i>Niger</i>
3.	<i>Iceland</i>	3.	<i>Ethiopia</i>
4.	<i>Norway</i>	4.	<i>Eritrea</i>
5.	<i>Guyana</i>	5.	<i>Malawi</i>
6.	<i>Suriname</i>	6.	<i>Djibouti</i>
7.	<i>Austria</i>	7.	<i>Chad</i>
8.	<i>Ireland</i>	8.	<i>Benin</i>
9.	<i>Sweden</i>	9.	<i>Rwanda</i>
10.	<i>Switzerland</i>	10.	<i>Burundi</i>
*based on resources and access to water Source: World Poverty Index			

**Global Consolidation**

The water sector has been under consolidation for some time and it appears that this trend should continue in selected areas in the future. While we have seen the number of publicly traded water utilities diminish over the last ten years in the U.S., the emergence of new foreign water utilities and the entrance of private equity into the regulated market in certain geographic areas leads us to believe that the buying and selling of water companies should remain alive and well.

Remember, the regulatory aspect of the business is a driving force behind municipalities moving towards consolidation and privatization. The private sector offers a viable alternative to governments that do not have the financial resources to invest in infrastructure needs.

From large conglomerates to small companies, the water market has experienced a significant number of merger and acquisition activities in all of the sub sectors. New entrants into the space appear with regularity now, compared to a decade ago. The economies of scale that can be achieved through continued consolidation coupled with the returns that investors in the sector have seen over the last five years makes sense and is an enduring theme for the foreseeable future.

Private equity is likely to continue to be the new player on the block in the water sector. While there is a cloud of uncertainty if the internal rate of return will be high enough for investors to stomach, the prevailing attitude appears to be that these firms are in it for the long haul.

We believe the characteristics of the water business make it a natural for private equity:

- Consistent growth over long periods of time
- High cash flow/high profitability
- Experienced management

***Our Final Thoughts - Investing in Water***

As we state the case for global water stock investing, one theme rings clear. As we watch large conglomerates and private equity make significant investments in water, there is a common underlying premise: there is not enough water to satisfy demand and it will likely become worse before solutions are provided that make it better.

*The sheer scarcity of water makes it more valuable than oil TODAY.* Long under priced, the cost of water should continue to climb as sources diminish and usage increases. Already certain forms of potable water are more valuable than oil. Bottled water sells for roughly \$1.50 a liter at the gas station right now, while gasoline sells for around \$2.50 a gallon. With 3.78 liters in a gallon, bottled water would be selling for \$5.67 a gallon—twice the price of gasoline.

While we teeter on the brink of a looming global crisis, the fact remains that water is virtually inelastic— as prices rise, consumption does not decrease. The correlation between scarcity and cost remains basically non-existent. This phenomenon has been enjoyed by the developed nations for quite a long time. We are strong proponents of the belief that water will likely be bought and sold in much the same ways as other commodities. Price expansion will be driven by scarcity or the need to move it from the retention source to the point of use.

The water industry from a global perspective offers a diversification unmatched by other sector plays. We look at the overall water market as "sectors within a sector" exposing investors to a broad range of industrial companies that service the global water market. These companies possess a strong customer base, sustainable and predictable contract awards and an ever-expanding need for the product that they produce and help supply.

Our enthusiasm for the water sector long term remains intact. Although one has to be cognizant of the global nature of the investment and manage the risk/reward accordingly, the prospects for global water companies and their outlook have never been stronger.

*William S. Brennan  
wbrennan@aquaterraam.com  
Aqua Terra Asset Management  
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The S&P 500 Index is an unmanaged index generally considered to be representative of the large-cap segment of the market. The MSCI World Index is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. As of June 2006 the index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The Russell 2000<sup>®</sup> Index is an unmanaged index generally considered to be representative of the small-cap segment of the market. It measures the performance of the 2,000 smallest companies in the Russell 3000<sup>®</sup> Index. The Russell 2000 Index represents approximately 10% of the total market capitalization of the Russell 3000 Index. The NASDAQ Composite is market-value weighted index of all common stocks listed on Nasdaq. The Dow Jones Industrial Composite is the most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials.