



# POLARIS

CAPITAL MANAGEMENT, LLC

121 High Street  
Boston, Massachusetts 02110  
Telephone (617) 951-1365  
[polariscapital.com](http://polariscapital.com)

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**POLARIS CAPITAL MANAGEMENT, LLC**  
125 Summer Street, 14<sup>th</sup> Floor – Boston, MA 02110  
617-951-1365 or [info@polariscapital.com](mailto:info@polariscapital.com)

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## **INTERNATIONAL PORTFOLIOS**

### FOURTH QUARTER 2008 PERFORMANCE ANALYSIS:

Volatility punctuated the fourth quarter, with country and industry factors having a more pronounced impact on individual holdings. Polaris's research focuses on companies with strong cash flows and low debt levels; yet in some instances, individual stock fundamentals were overwhelmed by country and industry factors.

Such an effect was evidenced in financials, as the entire sector declined due to dramatic failures of some large organizations and questions surrounding bank bailout programs. The portfolio stocks generally avoided subprime/overleveraged conditions, keeping fundamentals (strong balance sheets, good customer base and clean loans) intact, yet stock prices dropped. We believe holding select stocks at such depressed valuations may invariably result in strong performance over the long term.

Country factors evolved into global economic concerns, as constrained credit dampened demand for goods and services. Materials, industrials and consumer discretionary were negatively impacted as a result.

Consumer discretionary stocks relinquished some of their gains from the third quarter. Since December 2007, homebuilders have been burdened by lagging sales. Yet many of these companies had strong balance sheets allowing them to weather difficult market cycles. In the fourth quarter, these companies continued to be proactive in their efforts to stave off future declines. For example, Persimmons renegotiated its debt, while other builders are actively seeking alternatives to generate cash and resolve debt concerns.

During the fourth quarter, the holdings in the telecommunications and utilities sectors had relative outperformance against the MSCI EAFE Index benchmark. We invested in the telecom and utilities sectors due to the stability of their cash flows. Many of these companies were based in Japan, including telephone operator KDDI Corporation, utility companies Kansai Electric Power and Tokyo Electric Power and within consumer staples, milk producer Meiji Dairies. In the depressed consumer discretionary market, Culture Convenience, a Japan-based holding company in the operation of video/music rental chains, also gained substantially. The Japanese Yen appreciation further helped domestic-oriented stocks, with many of these stocks gaining 20% to 35%.

### 2008 REVIEW

Of the entire decline in 2008, approximately 85% was due to four sectors: materials, financials, industrials, and consumer discretionary, in order of importance. The portfolios' strong relative outperformance in information technology, telecommunications, and utilities sectors were not enough to offset the underperformance in other sectors.

Depressed materials stock prices were evident worldwide, ranging from Australia's diversified commodities company, BHP Billiton, to South African holdings, Metorex and Sappi. It should be noted that for the year, the portfolio's materials holdings performed better than the index's sector.

The portfolios' financial holdings were not immune to worldwide concerns surrounding large institutional failures (none of which were held by the Fund) and governmental bank bailout programs. Such concerns affected bank performance in the U.K, Ireland and Belgium.

Knowing the portfolio held stocks benefiting from global growth, we invested in more defensive sectors to balance this exposure, which helped performance in information technology, telecommunication services and utilities. Consequently, companies in these sectors had more stable cash flows unaffected by current economic volatility. The holdings in these sectors not only protected value, but also provided diversification in these times of market turbulence.

Consumer discretionary results were negatively affected by U.K. homebuilders, which underperformed due to house and land price declines triggered by reduced mortgage lending and buyer apprehension. The dramatic drop in homebuilder valuations anticipates more drastic declines in fundamentals than we believe to be realistic over the next three to five years. Thus far, these companies have preserved cash flow by rapidly decreasing costs, quickly controlling new building to match decreasing sales rates and paying down debt, all of which have allowed the firms to avoid issuing new equity at depressed valuations and preventing dilution. We continued to invest cautiously in consumer-oriented sectors, favoring select companies with substantial free cash flow and strong corporate teams.

A hallmark of Polaris's stock selection strategy is to pinpoint companies that have flexible business models with a base level of service business, not solely new growth business. If a crane, elevator, escalator or factory stops running entirely, those critical elements will have to be repaired or replaced with new parts. As such, service businesses within the industrial sector historically have provided strong margins and sustainable cash flow even in the worst of economic conditions.

#### FOURTH QUARTER 2008 ASSET ALLOCATION:

Based on the extreme declines in many company valuations worldwide, management is actively making portfolio changes and evaluating a host of new investments. During the quarter, we sold holdings in the material and industrial sectors where analysis revealed deterioration in fundamentals in relation to evolving market dynamics. Other stocks were sold when they advanced and reached their valuation limits. By executing such sells, management was able to improve the valuation of the portfolio and reduce exposure in some sectors that may experience further weakness.

The portfolio remains overweight in Scandinavian countries, while investments in continental Europe were less heavily weighted. The following table shows the asset allocation at December 31, 2008.

	<i>EAFE</i>	Portfolio									
	<i>Weighting</i>	Weighting	Energy	Utilities	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Information Technology
N. America	0.00%	1.39%	0.00%	0.00%	1.39%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Japan	25.25%	21.09%	0.00%	4.21%	4.00%	5.19%	1.05%	4.52%	0.00%	0.00%	0.00%
Other Asia	9.14%	9.16%	0.96%	0.00%	2.43%	0.00%	0.00%	0.00%	0.00%	0.00%	2.89%
Europe	60.75%	39.66%	0.70%	0.00%	9.73%	8.19%	10.46%	2.14%	0.00%	8.43%	0.00%
Scandinavia	4.86%	13.54%	0.00%	0.00%	0.00%	7.58%	2.55%	0.00%	0.00%	3.41%	0.00%
Africa & S. America	0.00%	2.83%	2.45%	0.00%	0.39%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Cash	0.00%	12.33%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Industry Totals		<u>100.00%</u>	4.11%	4.21%	17.94%	20.97%	14.06%	6.66%	0.00%	11.84%	2.89%
<i>Market Weighting</i>	<u>100.00%</u>		<u>11.63%</u>	<u>5.73%</u>	<u>5.84%</u>	<u>10.92%</u>	<u>8.87%</u>	<u>11.09%</u>	<u>11.86%</u>	<u>18.58%</u>	<u>10.23%</u>

Table may not cross foot due to rounding.

#### INVESTMENT ENVIRONMENT AND STRATEGY:

Without clear visibility to an end in the current recession, companies worldwide have reacted with amazing swiftness to reduce their cost basis. Such efforts have created strong macro-economic

headwinds, as cutbacks have created more unemployment and contributed to investor pessimism. In light of these developments, we believe the prudent course of action is to remain cautious and watchful of economic trends.

On a brighter note, there are several factors that may provide the needed stimulus for economic improvement. First, oil and other price declines will signal lower heating and transportation costs that previously contributed to material declines in disposable incomes in large consuming countries such as the U.S. During the past few years, oil rose from \$25 to \$147 a barrel. The negative impact on consumers' cash flow was underappreciated. Likewise, the stimulative effect of the recent drop in oil below \$40 may also be underappreciated.

Although creating more unemployment, companies that are restructuring can stabilize the cost structure of the economy with flexibility to hold up cash flows better than in past recessions. In addition, massive amounts of stimulus are being injected into economies by governments worldwide. All of these actions may ultimately have a positive effect on the economy despite the headwinds each catalyst may represent.

We have been nimble enough to make changes to try to avoid further capital declines, reducing materials exposure, while shifting weightings to companies that have experienced stronger cash flows and low levels of debt. Companies that might experience refinancing difficulties or sustain lower cash flows have been sold.

We have retained positions that may weather further macro-economic declines, with the potential for dramatic increases when the markets return to normalized levels. We strongly believe that valuation declines have overshot the fundamental values of the portfolio companies. Moreover, there is growing evidence that portfolio companies with strong cash flows and manageable debt levels may be growing stronger as the credit crisis persists and competitors struggle or fail. When the economy reaches bottom, and finally turns, the portfolios should be well situated with strong performing companies. The value of having investors who understand and act in accordance with this philosophy cannot be over-emphasized. Investors tend to buy when returns have been positive, and sell when returns turn negative.

In conclusion, 2008 performance was unsatisfactory. Nevertheless, we remain confident that the investment philosophy, discipline and current strategy will result in investments that should be fundamentally sound in the current economic crisis.